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How Did Heavily Indebted Poor Countries Become Heavily Indebted? Reviewing Two Decades of Debt Relief

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Summary. — The paradox of debt is that heavily indebted poor countries (HIPCs) became heavily indebted *after* two decades of debt relief efforts. Average policies in HIPCs 1980–97 were worse than other less-developed countries (LDCs), controlling for income. Terms of trade and wars do not show a different trend in HIPCs than in non-HIPC LDCs. Financing HIPCs shifted away from private and bilateral nonconcessional sources toward International Development Assistance and other multilateral concessional financing—but this implicit form of debt relief also failed to reduce net present value debt. The record is not encouraging for the success of current debt relief efforts.

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Key words — debt, Africa, adjustment, International Organizations, foreign aid, World Bank/IMF policies

1. INTRODUCTION

The central paradox of the heavily indebted poor countries (HIPCs) is that they became heavily indebted after two decades of partial debt relief and concessional lending. How did this happen? This may suggest that the factors that lead to high debt are long-lasting and not easily changed by debt relief. Consider the following example.

The HIPC of Haiti is not growing. The ratio of foreign debt service to exports has reached 40%, well above the 20–25% thought to be “sustainable.”¹ The debt was accumulated not to finance productive investments, but to finance the government’s patronage employment and large military and police forces. Corruption has been endemic, so there is the suspicion that some of the proceeds of foreign loans found their way into the pockets of the rulers. This is a description of Haiti’s experience in the 90s. The 90s to which these facts refer are not the 1990s, but the 1890s.²

The problem of heavily indebted countries is not a new one. From the two Greek city-states who defaulted on loans from the Delos Temple in the fourth century BC to Mexico’s default on its first foreign loan after independence in 1827 to Haiti’s 1997 ratio of debt to exports of 484%,

debt servicing difficulties have been a feature of the world economy throughout history.³

The problems of the HIPCs are very much in the news today (Third World debt was even mentioned in the hit movie *Notting Hill*, starring Hugh Grant and Julia Roberts.) A coalition of nongovernmental organizations called Jubilee 2000 asked for a write-off of all debt of poor countries on the occasion of the turning of the millenium (Jubilee 2000). Support for Jubilee 2000 has been expressed by such diverse figures as Bono from the rock group U2, the

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60 Pope, Jeffrey Sachs, Muhammad Ali, Mikhail
61 Gorbachev, and the Dalai Lama.⁴ Jubilee 2000
62 said that with debt forgiveness, “the year 2000
63 could signal the beginning of dramatic im-
64 provements in healthcare, education, employ-
65 ment and development for countries crippled
66 by debt.”⁵

67 Demonstrators from Washington to Prague
68 to Gothenburg to Genoa have thrown stones
69 for debt relief. The successor to the Jubilee 2000
70 movement is a coalition called Jubilee Plus,
71 which calls for an unconditional cancellation of
72 debt of the poor countries.⁶ Kofi Annan in
73 April 2001 noted

The Jubilee 2000 movement to cancel the debts of the poorest countries was an inspiration to us all. But its work did not finish with the Jubilee Year. We should all be grateful that it is carrying on in the short term as “Drop the Debt,” and broadening its agenda. ... In the Millennium Declaration, world leaders called for all the bilateral debts of the least developed countries to be cancelled, in return for their making demonstrable commitments to poverty reduction. And they promised to deal “comprehensively and effectively” with the debt problems of low- and middle-income countries.

86 The World Bank and the International
87 Monetary Fund (IMF) now have a program
88 called the HIPC initiative to provide debt
89 writedowns—including for the first time,
90 writedowns of IMF and World Bank claims in
91 present value terms—for poor countries with
92 good policies. The G-7 summit in Cologne in
93 June 1999 and the World Bank/IMF annual
94 meetings in October 1999 agreed on an expan-
95 sion of this program, increasing the number of
96 eligible countries, speeding up the process of
97 receiving relief and increasing the amount of
98 debt relief provided for each country. The ex-
99 pansion increased the total cost—in net present
100 value terms—of the HIPC initiative from
101 US\$12.5 billion to US\$27 billion.⁷ The IMF,
102 World Bank, and other multilateral and bilat-
103 eral creditors had committed HIPC debt relief
104 to 26 countries by April 1, 2001, for total
105 commitments of \$40 billion. (The World Bank
106 defines 41 countries as heavily indebted poor
107 countries—HIPC. The HIPC problem has an
108 Africa slant, as 33 of the 41 HIPC are in Af-
109 rica; four are in Latin America. A number of
110 HIPC are in the midst of violent conflict and
111 so cannot be considered for debt relief yet.)
112 Jeffrey Sachs suggests that that the World
113 Bank, IMF, commercial banks and rich coun-
114 try governments could absorb a writeoff of the

\$106 billion the poorest countries currently owe 115
to them.⁸ 116

The only problem with these arguments for 117
the salutary effects of debt relief is the lack of 118
recognition that debt relief is not a new phe- 119
nomenon. In the past, debt relief brought little 120
of the benefits promised for a new wave of debt 121
relief. In fact, debt relief did not even bring a 122
reduction in debt, as poor country governments 123
borrowed anew until they had again become 124
heavily indebted. 125

Although there were intimations as long ago 126
as 1967 that “debt-service payments have risen 127
to the point at which a number of countries 128
face critical situations,” the current wave of 129
debt relief for poor countries really got under- 130
way in 1979.⁹ The 1979 World Debt Tables of 131
the World Bank noted “lagging debt payment” 132
on official loans to poor countries, although 133
“debt or debt service forgiveness has eased the 134
problems for some.” The 1977–79 UNCTAD 135
meetings led to official creditors writing off \$6 136
billion in debt to 45 poor countries. The mea- 137
sures by official creditors included “the elimi- 138
nation of interest payments, the rescheduling 139
of debt service, local cost assistance, un- 140
tied compensatory aid, and new grants to re- 141
imburse old debts.”¹⁰ 142

The 1981 Africa report by the World Bank 143
(usually known as the Berg Report) noted that 144
Liberia, Sierra Leone, Sudan, Zaire, and 145
Zambia (all of which would become HIPC) 146
had already experienced “severe debt-servicing 147
difficulties” in the 1970s and “are likely to 148
continue to do so in the 1980s.” The Berg Re- 149
port hinted of debt relief, namely “longer-term 150
solutions for debt crises should be sought” and 151
“the present practice of *donors* separating aid 152
and debt decisions may be counterproduc- 153
tive.”¹¹ 154

The 1984 World Bank Africa report was 155
more forthright: “where monitorable programs 156
exist, multiyear debt relief and longer grace 157
periods should be part of the package of fi- 158
nancial support to the program.”¹² The 159
wording got even stronger in the World Bank’s, 160
1986 Africa report: low income Africa’s fi- 161
nancing needs will “have to be filled by addi- 162
tional bilateral aid and debt relief.”¹³ The 163
Bank’s 1991 Africa report continued escalating 164
the rhetoric: “Africa cannot escape its present 165
economic crisis without reducing its debt bur- 166
den sizably.”¹⁴ 167

Meanwhile, the June 1987 G-7 summit in 168
Venice called for interest rate relief on debt of 169
low-income countries. The World Bank noted 170

171 “the past year has brought increasing recogni-
 172 tion of the urgency of the debt problems of the
 173 low-income countries of sub-Saharan Af-
 174 rica.”¹⁵ One year later, the June 1988 G-7
 175 summit in Toronto agreed on a menu of op-
 176 tions, including partial forgiveness, longer ma-
 177 turities, and lower interest rates (these became
 178 known as the “Toronto terms”).¹⁶ Meanwhile,
 179 in order to help African countries service their
 180 official debt, the World Bank in December 1987
 181 initiated a special program of assistance (SPA)
 182 to low-income Africa. The IMF complemented
 183 the SPA with the enhanced structural adjust-
 184 ment facility. Both programs sought to provide
 185 “substantially increased, quick-disbursing,
 186 highly concessional assistance to adjusting
 187 countries.”¹⁷ The 1990 Houston G-7 summit
 188 considered “more concessional reschedulings
 189 for the poorest debtor countries.” The UK and
 190 the Netherlands proposed “Trinidad terms”
 191 that would increase the grant element of debt
 192 reduction to 67%, from 20% under the “To-
 193 ronto terms.”¹⁸ The 1991 London G-7 summit
 194 agreed “on the need for additional debt relief
 195 measures... going well beyond the relief al-
 196 ready granted under Toronto terms.”¹⁹
 197 Through November 1993, the Paris Club (the
 198 club of official lenders) applied enhanced To-
 199 ronto terms that were even more conces-
 200 sional.²⁰ In December 1994, the Paris Club
 201 announced “Naples terms” under which eligi-
 202 ble countries would receive yet additional debt
 203 relief.²¹

204 Then, in September 1996, the IMF and
 205 World Bank announced the HIPCs debt ini-
 206 tiative, which was to allow the poor countries
 207 to “exit, once and for all, from the rescheduling
 208 process” and to resume “normal relations with
 209 the international financial community, charac-
 210 terized by spontaneous financial flows and the
 211 full honoring of commitments.” The multilat-
 212 eral lenders for the first time would “take ac-
 213 tion to reduce the burden of their claims on a
 214 given country,” albeit conditional on good
 215 policies in the recipient countries. The Paris
 216 Club at the same time agreed to go beyond
 217 Naples terms and provide an 80% debt reduc-
 218 tion in net present value terms.²²

219 Finally, as we saw above, the IMF and
 220 World Bank expanded the “once and for all”
 221 program in, 1999. Nor is the story over, as in-
 222 dependent analysts like Birdsall, Williamson,
 223 and Deese (2002) point out that there remain
 224 HIPCs outside the program such as Indonesia,
 225 Nigeria, and Pakistan, while the IMF and
 226 World Bank assumed optimistic projections for

export growth to make even existing HIPCs’
 227 post-relief situation manageable.²³ 228

Besides explicit debt relief, there also has
 229 been an implicit form of debt relief going on
 230 throughout the period, which is the substitution
 231 of concessional debt for nonconcessional debt.
 232 It’s remarkable that the net present value of
 233 future debt service for HIPCs rose throughout
 234 the period despite the large net transfers of re-
 235 sources from concessional lenders like the In-
 236 ternational Development Association of the
 237 World Bank and the concessional arms of bi-
 238 lateral and other multilateral agencies.

The necessity to provide continuing waves of
 240 debt relief one after another, from UNCTAD
 241 to Venice to Toronto to Houston to Trinidad
 242 to London to Naples to HIPC to expanded
 243 HIPC, all the while substituting concessional
 244 for nonconcessional debt, may suggest some-
 245 thing is wrong with the implementation of debt
 246 relief. There is the paradox that a large group
 247 of countries came to be defined as heavily in-
 248 debted at the *end* of two decades of debt relief
 249 and increased concessional financing. 250

This paper reviews possible explanations. 251
 252 The revealed preference of debtors for high
 253 debt may simply lead to new borrowing to re-
 254 place old cancelled debts. Even if borrowing is
 255 constrained, poor countries that have a high
 256 discount rate against the future may run down
 257 country assets. This is the external adjustment
 258 equivalent to the fiscal adjustment “illusion”
 259 discussed by Easterly (1999a).

The granting of progressively more favorable
 260 terms for debt relief may also have perverse
 261 incentive effects, as countries borrow in anti-
 262 cipation of debt forgiveness and delay policy re-
 263 forms waiting for the best deal. Burnside and
 264 Dollar (2000) and World Bank (1998b) suggest
 265 that aid does not raise growth in countries with
 266 poor economic policies. The World Bank’s
 267 latest Africa report (World Bank, 1994b) sug-
 268 gested that many African countries failed to
 269 depart from poor economic policies during the
 270 process of receiving adjustment loans from the
 271 World Bank and IMF. 272

Since private lending withdraws because of
 273 the poor creditworthiness of HIPCs, the pro-
 274 cess of debt relief has also led to a substitution
 275 of official lending for private lending and for-
 276 eign direct investment (FDI), which raises the
 277 concern that official lending may have not fol-
 278 lowed the same standards of creditworthiness
 279 as private lending. There has been a redistribu-
 280 tion of roles even among official lenders,
 281 with some agencies making net transfers (debt
 282

283 flows net of interest) to HIPCs and others re-
284 ceiving net transfers from HIPCs.

2. THEORETICAL CONSIDERATIONS ON DEBT RELIEF

287 A country that has gotten an “excessive”
288 external debt may be one with a high discount
289 rate against the future—reflecting factors such
290 as a profligate government, political instability,
291 or interest group polarization.²⁴ After receiv-
292 ing debt relief, the high-discount rate country
293 would like to accumulate the same amount of
294 external debt again. There will be an amount
295 of new borrowing corresponding to the amount
296 of debt relief, until the old ratio of net worth to
297 GDP is restored. Alternatively, debt relief
298 conditionality could try to control new bor-
299 rowing by constraining a country’s noninterest
300 current account deficit. Even this constraint
301 could be ineffective, however, because a coun-
302 try can reduce its assets to restore its desired
303 low level of net worth in the long run. Finally, a
304 government can impose its own high discount
305 rate on the rest of the economy through policies
306 that tax private sector capital accumulation. If
307 the government’s discount rate is unchanged
308 before and after debt relief, then these bad
309 policies will persist with debt relief.

310 Poor countries may have a higher discount
311 rate because individuals with shorter expected
312 lifetimes have higher discount rates (Blanchard
313 & Fischer, 1989, Chap. 3.3), and lifetimes are
314 shorter in poor countries. Alternatively, the
315 government in poor countries may have a
316 higher discount rate because its expected tenure
317 in office is shorter, because poor countries have
318 more political instability (Easterly, 1999b). The
319 government may then impose its higher dis-
320 count rate on the whole economy, as I argue
321 below.

322 The “high discount rate” can also be seen as
323 shorthand for political economy factors that
324 cause the government to overspend, prey on
325 private enterprise, and overextract rents from
326 the economy to distribute as patronage. There
327 is a large literature on the “neopatrimonial”
328 and “predatory” state (see Nafziger, 1993 and
329 Van de Walle, 2001 for African examples). The
330 ruling elite in impoverished societies keeps itself
331 in power by buying off potential rivals and re-
332 warding supporters, not to mention repressing
333 opposition by force. All of this requires the
334 state to mobilize resources, which it does by
335 borrowing against the future as well as explic-

itly or implicitly taxing current production at 336
the cost of future growth. Given the elite does 337
not feel secure, the future does not have a 338
strong voice in elite circles. 339

Therefore, if the discount rate is unchanged 340
before and after debt relief, the government will 341
respond to debt relief by new borrowing until 342
the old ratio of net worth to consumption is 343
restored. In the same vein, if the terms of 344
lending are made more favorable by substitut- 345
ing concessional for nonconcessional debt then 346
countries will reborrow to maintain the net 347
present value of debt service. Alternatively, the 348
country could run down assets to restore the 349
old ratio of net worth to consumption.²⁵ (The 350
country does benefit from higher consumption 351
than would have been possible in the absence of 352
debt relief.) 353

On the other hand, what would happen if the 354
discount rate of the government changes? If a 355
reformist government succeeds a spendthrift 356
one, then debt relief would successfully provide 357
a painless transition to a higher ratio of net 358
worth to consumption (higher assets and lower 359
debt to consumption ratios). 360

Above, I described one possible reaction to 361
debt relief is for the country to reborrow 362
enough to restore the old ratio of net worth to 363
GDP. But, the external creditors (many of them 364
official lenders) may impose a limit on bor- 365
rowing. A common formulation is to provide 366
enough loans as to maintain a certain target 367
debt ratio (usually a ratio to GDP or to ex- 368
ports). I will suppose here that a country’s ex- 369
ternal creditors supply an amount of credit 370
such that its debt to GDP ratio is equal to some 371
stable constant.²⁶ 372

Suppose that debt relief lowers the permitted 373
debt ratio and imposes the lower level of bor- 374
rowing associated with maintaining the new 375
debt ratio. This kind of debt relief could simply 376
cause a one-for-one reduction in national assets 377
with the amount of debt reduction as percent- 378
age of GDP. Since liabilities have been reduced, 379
assets will in the long run decrease as well. 380
Being prevented from running up as much debt 381
as previously to finance consumption, the 382
country will compensate by running down as- 383
sets instead. If the current debt level was “un- 384
sustainable” in that it represented too heavy a 385
burden relative to assets, then the new debt 386
level will be equally “unsustainable” because 387
society’s assets will decrease with the debt.²⁷ 388

So far I have not focused on the government, 389
leaving it unclear whether a high discount rate 390
could also characterize the private sector. We 391

would generally expect that the government will be more impatient than the private sector, because of uncertainty of tenure and lower concern for future generations of government. Governments in poor countries are subject to greater instability (e.g., more coups) than in rich countries, thus have shorter expected tenures in office, and thus have a higher discount rate than in rich countries. Governments in poor countries could however, impose their high discount rate on the whole economy through high tax rates and other policies adverse to growth.

The government has a tradeoff between taxing the private sector to finance government consumption today versus government consumption tomorrow financed by the future tax base (which is decreasing in the tax rate today). The private sector accumulates net worth and grows faster the more that the rate of return to capital exceeds the discount rate, except that the government imposes a tax on the rate of return to capital.

The optimal tax rate for the government is increasing in the government's discount rate. Intuitively, the government is trading off consumption today (increasing in the tax rate) versus consumption tomorrow (increasing in private wealth tomorrow and thus decreasing in the tax rate). A high discount rate government will choose to tax the private sector heavily. The government will succeed in imposing its intertemporal preferences on the whole economy through its policies. The policies may include predatory behavior that implicitly rather than explicitly taxes capital accumulation, such as high corruption, real overvaluation, a high black market premium, high inflation, or financial repression.

The empirical prediction is that a high discount rate government will have bad policies that explicitly or implicitly tax the private sector. If the government's high discount rate is unchanged over time, then we would expect these bad policies to remain unchanged before and after debt relief.

There are other ways in which debt relief creates perverse incentives for new borrowing. The way that debt relief has been granted, offering progressively more favorable terms over time for two decades, also has perverse incentive effects. Most obviously, it creates moral hazard incentives to borrow in the expectation that part of this debt will be forgiven.

More subtly, incremental debt relief creates incentives to delay policy reforms, waiting for a

progressively higher "price" at which to "sell" 448 policy reforms. If the rate at which the amount 449 of relief is increasing exceeds the international 450 market interest rate, then policy-makers will 451 wait to "sell" policy reforms. 452

Going further, we can think of a Hotelling-type model for the depletion of the "stock" of 453 needed policy reforms. If there is a supply of 454 needed reforms in HIPCs and a demand for 455 reform by donors, then the equilibrium "price" 456 of a marginal reform will rise at the rate of 457 interest. If HIPCs reform "too fast," this would 458 drive down the price below the interest rate 459 trajectory—which means that HIPCs prefer to 460 wait in such a case, driving the price back up to 461 the equilibrium interest rate trajectory. This 462 suggests policy-makers will adopt a gradualist 463 rather than big-bang strategy of economic re- 464 form in response to gradual debt relief, only 465 gradually depleting their stock of "necessary 466 reforms." This result is undesirable because it 467 means that countries will be stuck longer with 468 poor policies. 469 470

There is also a perverse incentive created by 471 the response of debt relief to *changes* rather 472 than the *level* of policies. Obviously, countries 473 with worse initial policies have more scope for 474 improvement. If debt relief responds exclusively 475 to *changes*, it may result in aid resources going 476 to countries with a worse *level* of policies on 477 average. Countries could even engage in zig-zag 478 behavior, getting debt relief as they improve 479 policies and then backsliding to the old level of 480 policies. This is the kind of result that Burnside 481 and Dollar (2000) depicted as unproductive aid. 482

Finally, I have been dealing with the *demand* 483 for external loans, but not with their *supply*. 484 Countries that have negative growth, falling 485 assets, bad policies, and increasing debt are 486 poor credit risks. The prospect of debt for- 487 giveness also would tend to chill private lend- 488 ing. We could expect that private creditors will 489 stop lending at some point. If multilateral and 490 other official lenders perceive their role as 491 "filling the financing gap," then their role will 492 increase over time in countries with falling as- 493 sets and increasing debt. 494

The official lenders may want to keep lending 495 even when the loans do not promote develop- 496 ment because multilateral and donor agencies 497 are often rewarded for volumes of assistance 498 rather than results. The official lenders may feel 499 the need to keep lending so the country does 500 not default on earlier obligations to private or 501 official creditors. The International Financial 502 Institutions will thus fail to enforce conditions 503

504 even as they keep giving new loans. (The World
505 Bank (1998b) mentioned that it had given loans
506 to finance the same agricultural policy reforms
507 in Kenya five separate times.) The official
508 lenders should then bear some of the blame for
509 financing bad governments who pursue policies
510 detrimental to their own citizens.

511 I will not try to distinguish these stories from
512 each other in explaining becoming heavily in-
513 debted after debt relief. One alternate hypoth-
514 esis to these that I will test would be that
515 HIPC's became heavily indebted through bad
516 shocks such as adverse terms of trade growth
517 and war. I test this hypothesis in the results
518 below. The other testable predictions from
519 these stories are that high-debt countries will
520 show other signs of heavily discounting the
521 future (such as asset decumulation), that new
522 borrowing will be associated with debt relief,
523 and that policies will be worse in high debt
524 countries. The irresponsible official lender story
525 predicts that public debt will substitute for
526 private debt. These are sharp predictions con-
527 trasting with conventional wisdom that debt
528 relief finances or encourages asset accumulation
529 and that actual debt falls over time with im-
530 proved terms on the debt.

3. THE EMPIRICAL EXPERIENCE WITH DEBT RELIEF

533 We can examine successively the response of
534 new debt and assets to debt relief. I examine the
535 41 HIPC's as so classified by the IMF and
536 World Bank.²⁸ The countries are Angola, Be-
537 nin, Bolivia, Burkina Faso, Burundi, Camer-
538 oon, Central African Republic, Chad, Congo
539 (Dem. Rep.), Congo (Rep.), Côte d'Ivoire,
540 Equatorial Guinea, Ethiopia, Ghana, Guinea,
541 Guinea-Bissau, Guyana, Honduras, Kenya,
542 Lao PDR, Liberia, Madagascar, Malawi, Mali,
543 Mauritania, Mozambique, Myanmar, Nicara-
544 gua, Niger, Rwanda, Sao Tome and Principe,
545 Senegal, Sierra Leone, Somalia, Sudan, Tan-
546 zania, Togo, Uganda, Vietnam, Yemen, and
547 Zambia.

548 The reader may worry that we have a sample
549 selection bias, because these countries were
550 classified as HIPC's at the *end* of the period.
551 Hence, it would not be so surprising if we find
552 that things did not go well for these countries in
553 the period prior to their classification. This
554 sample selection is justified, however, because it
555 is this group that the debt relief efforts targeted.
556 We can think of the following results as docu-

menting the extent of adverse selection in debt
relief efforts. We will retrace the path of this
group to see if the prediction of unchanged
behavior before and after debt relief hold re-
lative to other developing countries.

(a) *Debt accumulation and asset decumulation*

The theoretical stories predicted that a high-
discount rate country would be characterized
not only by high debt accumulation but also by
low asset accumulation, or even asset decu-
mulation. This contrasts with the traditional
view that debt accumulation finances asset ac-
cumulation. The natural place to look for evi-
dence on asset accumulation is investment. This
is a poor indicator, however, as Devarajan,
Easterly, and Pack (2001) have found that
traditionally measured investment is not pro-
ductive in Africa where most of the HIPC's are
concentrated.

A better albeit indirect way of getting at
productive asset accumulation is to look at the
behavior of per capita output. If we take per
capita output as proportional to a broad con-
cept of productive capital per capita, including
physical and human capital, technological
capital, knowledge, etc., then the evolution of
per capita output would tell us something
about the tangible and intangible forms of asset
accumulation.

The natural measure of HIPC's' external lia-
bilities is their debt to GDP ratio. But since
much of the HIPC's' debt is concessional, the
face value of the debt is a poor measure of the
debt burden. I use the present value of debt
service as a ratio to GDP as the debt indicator.
Surprisingly, despite the attention given to the
poor countries' debt problem, I was unable to
find time series of the present value of debt
service for HIPC's. (The World Bank's *Global
Development Finance* reports an estimate of the
present value of debt service for the latest year,
while earlier reports reported three year moving
averages going back to 1991. These moving
averages do not give internally consistent
numbers for individual years, so I do not use
them.) Using data on scheduled debt service
from the Debt Reporting System of the World
Bank, a time series 1979-97 for each of the
HIPC's' present value of debt obligations was
calculated for this paper.²⁹

Figure 1 shows the evolution of the HIPC's' per
capita output in 1997 prices and their median
debt to GDP ratio in present value
terms.³⁰ If we take the trend fall in output over

HIPCs AND DEBT RELIEF

7

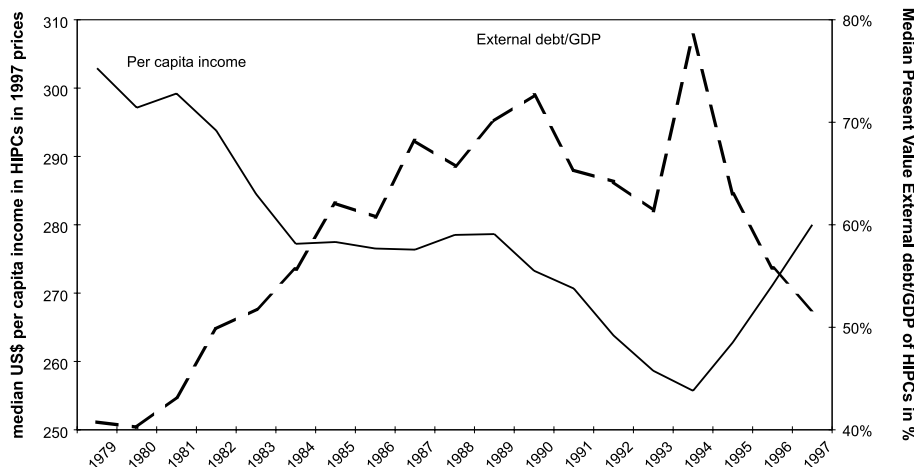


Figure 1. *External debt/GDP (present value terms) and per capita income in HIPCs.*

611 1979–97 as representing a drop in potential
 612 output, and potential output as proportional to
 613 a broad notion of productive assets, then there
 614 was asset decumulation at the same time as
 615 there was high debt accumulation. The HIPCs’
 616 debt problem arose not just because of new
 617 borrowing, but because of disinvestment in
 618 productive potential. This is consistent with a
 619 story in which the HIPCs can be characterized
 620 as persistently high discount rate countries.

621 There is some possibility of a break point
 622 toward the end of the period in which the debt
 623 ratio went down and output went up. This
 624 corresponds to the period after the new HIPC
 625 debt relief initiative was launched, which could
 626 indicate more success for this latest debt relief
 627 attempt. But, the period after the break is too
 628 short to evaluate whether it is a permanent
 629 change.

630 I next turn to oil production, for which we
 631 have 1987–96 data. There are 10 HIPCs that
 632 are oil producers. Oil production is a form of
 633 asset decumulation, since it takes an asset in the
 634 form of oil in the ground and turns it into cash
 635 that can be an alternative form of financing
 636 consumption if conventional debt is constrained.
 637 Did HIPCs have higher oil production
 638 growth over this period of debt relief than did
 639 the non-HIPC oil producers? The answer is yes.
 640 The average log growth in oil production is 6.6
 641 percentage points higher in the HIPCs than in
 642 the non-HIPCs, which is a statistically significant
 643 difference. The average log growth in oil
 644 production in HIPCs was 5.3%; in non-HIPCs,
 645 it was –1.3%.

Another form of asset decumulation taking
 646 place at this time was sales of state enterprises
 647 to foreign purchasers. We have data on priv-
 648 atization foreign exchange revenues for 1988–
 649 97. Over this period, total sales of state enter-
 650 prises in the HIPCs amounted to US\$4 billion.
 651 This is an underestimate, because not all priv-
 652 atization revenues are recorded in the official
 653 statistics. Even using this flawed data, there is a
 654 positive and significant correlation of 0.35
 655 across the 41 HIPCs between the amount of
 656 debt forgiveness and the amount of privatiza-
 657 tion foreign exchange revenues. Privatization
 658 may have been done for efficiency reasons or
 659 even as a condition for debt relief, but it also
 660 may suggest a high discount rate economy
 661 running down its assets. 662

(b) *Debt relief and new borrowing*

The data on debt relief from the World
 664 Bank’s World Debt Tables only go back to
 665 1989. The relationship between debt relief and
 666 new borrowing over this period is interesting:
 667 total debt forgiveness for 41 heavily indebted
 668 poor countries over 1989–97 totaled US\$33
 669 billion, while their new borrowing was US\$41
 670 billion. This seems to point in the direction of
 671 the prediction above that debt relief will be met
 672 with an equivalent amount of new borrow-
 673 ing.³¹ 674

Was new borrowing the highest in the
 675 countries that got the most debt relief? Running
 676 a regression for the 40 HIPCs that have com-
 677 plete data, there is a statistically significant as-
 678

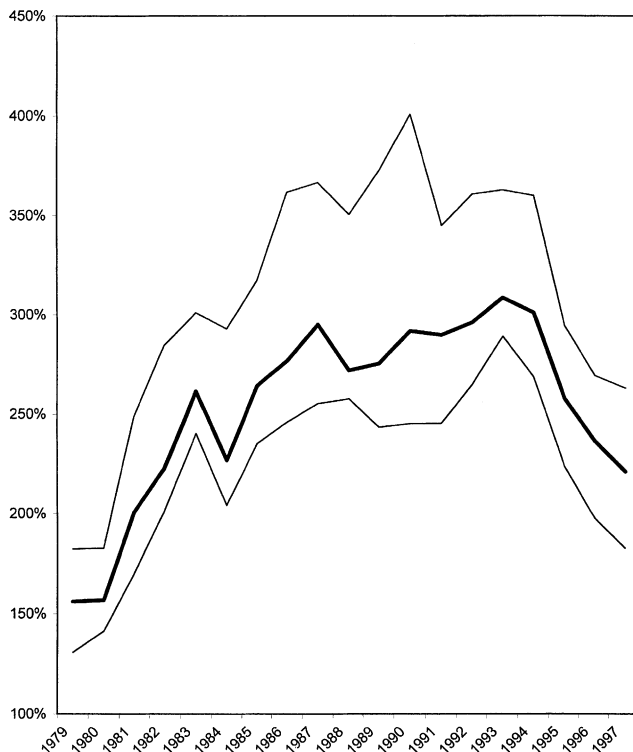


Figure 2. 95% confidence interval for median present value of debt of HIPCs as a ratio to exports.

679 sociation between average debt relief as a per- 703
680 cent of GDP and new net borrowing as per- 704
681 centage of GDP. The offset in this case is less 705
682 than one for one: one percentage point of GDP 706
683 higher debt forgiveness translated into 0.34% of 707
684 GDP new net borrowing. 708

685 Another bit of evidence that debt relief did 709
686 not lower debt significantly is to look at external 710
687 debt to export ratios over 1979–97. I again 711
688 use the present value of debt service as a mea- 712
689 sure of external debt, but now as a ratio to 713
690 exports. I again use 1979 as a base year because 714
691 it was the year the UNCTAD summit inaugu- 715
692 rated the current wave of debt relief. I have
693 data for 28–37 HIPCs over 1979–97. Despite
694 the ongoing debt relief, the median present
695 value debt to export ratio rose strongly during
696 1979–97 (Figure 2). We can see three distinct
697 periods: (i) 1979–87 when debt ratios rose
698 strongly; (ii) 1988–94 when debt ratios re-
699 mained constant; and (iii) 1995–97 in which
700 debt ratios fell. The behavior in periods (i) and
701 (ii) is consistent with failed debt relief, while the
702 drop in the last period may indicate that the

1996 HIPC debt relief program has been more 703
successful than earlier efforts. 704

705 Despite the drop in the last period, however, 706
707 the median debt to export ratio is statistically 708
709 significantly higher in 1997 than it was in 1979. 710
711 Again this result is not surprising given that we 712
713 have selected the sample based on their debt at 714
715 the end of the period. Still, it suggests that for a
large group of 41 countries, new borrowing
(more than) kept pace with the amount of debt
relief, as would have been predicted by the
model for countries with unchanged discount
rates.³²

(c) *Regression analysis of HIPCs’
macroeconomic imbalances and
country policies*

719 In this section, I develop summary statistics 719
720 of HIPCs’ policy stance. I regress an average 720
721 over the debt relief period 1980–97 of each 721
722 policy indicator or macroeconomic imbalance 722
723 on the log of initial income, and a dummy for 723

724 HIPC's for the whole sample of less-developed
725 countries (LDCs).

726 Table 1 shows the results. We see that the
727 average levels over 1980–97 of current account
728 deficits, budget deficits (with or without
729 grants), M2/GDP, and real overvaluation, were
730 worse for HIPC's. The differences in HIPC's'
731 real interest rate, black market premium, and
732 inflation rates from the rest of the LDC sample
733 are not statistically significant (although infla-
734 tion and real interest rates are marginally sig-
735 nificant at the 10% level).

736 The HIPC's also were worse on the broad
737 measure of policy given by the World Bank's
738 Country Policy and Institutional Assessment
739 (CPIA). This measure of policies not only in-
740 cludes a rating of policy stance, but also of
741 institutional quality—like the prevalence of
742 corruption. The HIPC's' average CPIA 1980–97
743 was worse than the CPIA for other LDCs.

744 The result on the current account deficit is
745 not surprising: obviously HIPC's got to be
746 HIPC's by borrowing a lot! The results on

747 policies are not as obvious, as the debt accu-
748 mulation could have come from bad external
749 shocks (on which more in a moment) rather
750 than bad policies like real overvaluation, low
751 financial depth, and poor CPIA.

752 Even more interesting is to examine the
753 composition of financing the current account
754 deficit. Table 2 shows some intriguing patterns.
755 First, HIPC's received less FDI than other
756 LDCs, controlling for income. This may be an
757 indirect indicator of the bad policies found on
758 the other indicators: investors do not want to
759 invest in an economy with high budget deficits,
760 high overvaluation, and high corruption. In-
761 vestors may also have worried what debt relief
762 may have meant for other external liabilities
763 like the stock of direct foreign investment. It
764 also is a confirmation of the prediction that
765 private capital flows will dry up in high dis-
766 count rate economies with falling assets and
767 increasing debt.

768 Second, despite their poor policies, HIPC's
769 received more in World Bank and IMF fi-
770

Table 1. Regression results for policies in LDCs 1980–97, controlling for income (sample of all LDCs)

| Dependent variable, average 1980–97 | Current account balance/GDP | | Budget deficit excl. grants/GDP | |
|--|---------------------------------|-------------|--|-------------|
| | Coefficient | t-Statistic | Coefficient | t-Statistic |
| Log income, 1979 | 0.08 | 0.11 | 1.47 | 2.08 |
| Dummy for HIPC's | -5.58 | -4.36 | -4.26 | -3.67 |
| R2 | 0.25 | | 0.32 | |
| # Observations | 77 | | 81 | |
| | Budget deficit incl. grants/GDP | | M2/GDP | |
| Log income, 1979 | -0.34 | -0.46 | 1.50 | 0.48 |
| Dummy for HIPC's | -4.97 | -3.94 | -15.65 | -2.96 |
| R2 | 0.19 | | 0.15 | |
| # Observations | 84 | | 83 | |
| | Log (1 + inflation rate) | | Index of overvaluation (based on Dollar, 1992) | |
| Log income, 1979 | 0.13 | 2.60 | 9.07 | 1.13 |
| Dummy for HIPC's | 0.15 | 1.79 | 64.19 | 4.92 |
| R2 | 0.08 | | 0.30 | |
| # Observations | 82 | | 68 | |
| | Real interest rate | | Log (1 + black market premium) | |
| Log income, 1979 | -0.01 | -0.47 | 0.04 | 0.60 |
| Dummy for HIPC's | -0.05 | -1.79 | 0.09 | 0.78 |
| R2 | 0.05 | | 0.01 | |
| # Observations | 74 | | 77 | |
| | CPIA (1–5 scale) | | | |
| Log income, 1979 | 0.07 | 0.72 | | |
| Dummy for HIPC's | -0.33 | -2.15 | | |
| R2 | 0.11 | | | |
| # Observations | 77 | | | |

Table 2. *Financing composition of debt accumulation, 1979–97*

| Dependent variable, average 1980–97 | FDI/GDP | | Coefficient | <i>t</i> -Statistic |
|--|---------------------------------------|---------------------|--------------------------------|---------------------|
| | Coefficient | <i>t</i> -Statistic | | |
| Log income, 1979 | 0.11 | 0.66 | | |
| Dummy for HIPCs | –0.84 | –2.92 | | |
| R2 | 0.17 | | | |
| # Observations | 77 | | | |
| | World Bank Financing/GDP | | IMF Financing/GDP | |
| Log income, 1979 | –0.40 | –3.76 | 0.05 | 0.41 |
| Dummy for HIPCs | 0.96 | 5.35 | 0.73 | 3.40 |
| R2 | 0.53 | | 0.15 | |
| # Observations | 83 | | 83 | |
| | World Bank share of disbursements/GDP | | IMF share of disbursements/GDP | |
| Log income, 1979 | –8.10 | –5.72 | 0.69 | 0.79 |
| Dummy for HIPCs | 7.17 | 3.14 | 4.37 | 3.12 |
| R2 | 0.54 | | 0.13 | |
| # Observations | 76 | | 76 | |

770 nancing than other LDCs. The result on World
 771 Bank financing is controlling for initial income
 772 (negatively related to World Bank financing).
 773 The effect (0.96% of GDP) is small relative to
 774 the size of the current account deficit, but large
 775 relative to the mean amount of World Bank
 776 financing (1.1% of GDP). The share of World
 777 Bank financing in gross disbursements also was
 778 significantly higher (by 7.2 percentage points)
 779 in HIPC than in non-HIPCs. This confirms the
 780 prediction that multilateral lenders “filling the
 781 financing gap” will have a significant role in
 782 financing high-discount rate economies.

783 The results are similar for the IMF. I re-
 784 gressed IMF financing on a constant, initial per
 785 capita income and the HIPCs dummy. The
 786 HIPC dummy is indeed significant. Like the
 787 World Bank HIPC dummy, the effect is small
 788 relative to current account deficits (0.73% of
 789 GDP), but large relative to the non-HIPCs
 790 average IMF financing (0.5% of GDP). The
 791 HIPC effect for the IMF’s share of disburse-
 792 ments is of the same sign and significant—the
 793 IMF had 4.4 percentage points more of gross

disbursements to HIPCs than to non-HIPCs, 794
 controlling for income. The HIPCs got to be 795
 HIPCs in part by borrowing from the World 796
 Bank and IMF. I will go into more detail on 797
 who gave loans to the HIPCs (and when) in a 798
 later section. 799

One explanation of the HIPCs’ becoming 800
 heavily indebted is that they suffered adverse 801
 terms of trade shocks. Table 3 shows, however 802
 that the least-squares log growth in terms of 803
 trade over 1979–97 was not significantly worse 804
 for HIPCs. The LDC sample as a whole shows 805
 significantly worsening terms of trade over 806
 1979–97, but the HIPCs do not stand out as 807
 any different than their less heavily indebted 808
 neighbors. 809

Another possible shock that might have 810
 caused HIPCs to have high debt ratios is war, 811
 since it both destroys productive assets and 812
 causes additional government spending that 813
 has to be financed. But, as shown in Table 3, 814
 HIPCs were not more likely to be at war than 815
 the rest of the LDC sample.³³ 816

Table 3. *Terms of trade shocks and war, 1979–97*

| Dependent variable, average 1979–97 | Least-squares log growth in terms of trade | | Percent of period at war | |
|--|--|---------------------|--------------------------|---------------------|
| | Coefficient | <i>t</i> -Statistic | Coefficient | <i>t</i> -Statistic |
| Log income, 1979 | 0.00 | –0.97 | –0.04 | –0.75 |
| Dummy for HIPCs | 0.00 | –0.05 | –0.09 | –1.10 |
| R2 | 0.02 | | 0.02 | |
| # Observations | 77 | | 76 | |

817 In sum, we have a pattern of poor policy
818 indicators that most needed to be improved to
819 avoid a debt crisis. Not surprisingly, HIPCs'
820 policies were worse precisely in those areas—
821 high current account deficits and budget defi-
822 cits—that led to high debt accumulation. Less
823 obvious were bad policies on financial repres-
824 sion and exchange rate overvaluation. This is
825 consistent with these countries having a high
826 discount rate that was unchanged before and
827 after debt relief. This is also consistent with
828 policy-makers waiting for the best deal during
829 the incremental process of debt relief. It is also
830 consistent with the moral hazard problem that
831 after the initial debt relief in 1979, HIPCs may
832 have rationally anticipated that much of their
833 new borrowing would be later forgiven.

(d) *Current account deficits and budget
deficits over time*

836 In addition to averages over 1980–97, it is
837 important also to look for trends. Did HIPCs'
838 policies get better over the two decades of debt
839 relief? On the current account deficit, perhaps
840 the most important measure of policy stance
841 for heavily indebted countries, the news is not
842 good. (This measure of the current account
843 deficit treats grants as revenue rather than fi-
844 nancing.) The median current account deficit
845 has stayed high and constant at around 7.5% of
846 GDP over the period of incremental debt relief
847 1979–97.

848 The budget deficit to GDP ratio also fails to
849 improve over the debt relief period 1979–97
850 (Figure 3), for a sample of 23–35 countries, if
851 anything deteriorating to the very high level of
852 around 10% of GDP. These figures treat grants
853 as a source of financing. This would be justified
854 if we think of grants as temporary, with the
855 donors planning that the country exit from
856 needing foreign aid after a certain interval. But,
857 grants in practice may be permanent and they
858 do not imply future debt servicing require-
859 ments, so it's of interest to see the budget deficit
860 including grants. The grant-inclusive budget
861 deficit still fails to improve for HIPCs (Figure
862 3).

863 The results on the current account deficit and
864 budget deficit do not show a clear improvement
865 in behavior during the process of incremental
866 debt relief. This is consistent with the HIPCs
867 being persistently high-discount rate econo-
868 mies.

(e) *Debt relief and other country policies
over time*

871 How have other HIPC policies behaved 871
872 during the period of incremental debt relief 872
873 1979–97? As noted in the theoretical section, 873
874 poor policies is one mechanism by which the 874
875 government imposes its own high discount rate 875
876 on the rest of the economy. There is also the 876
877 worry that countries would respond to incre- 877
878 mental debt relief by postponing policy re- 878
879 forms, waiting for a higher “price” at which to 879
880 “sell” policy reforms. Alternatively, countries 880
881 could slowly reform, selling off pieces of reform 881
882 as the price rises. The intent of the debt relief 882
883 efforts, in contrast, was that policies would 883
884 improve immediately as a condition for getting 884
885 new debt relief. Which happened? 885

886 The evidence is very mixed, as shown in 886
887 Figure 4. The real interest rate for HIPCs is an 887
888 indicator of either the private return to capital 888
889 if interest rates are uncontrolled or financial 889
890 repression if there is a nominal interest rate 890
891 ceiling. HIPCs had flat real interest rates over 891
892 time. Contrary to the stereotype of HIPCs as 892
893 financially repressed, the median real interest 893
894 rate was positive for most of the period (al- 894
895 though not significantly different than zero). 895

896 A different variable related to financial re- 896
897 pression, the ratio of M2 to GDP (financial 897
898 depth) in HIPCs, shows a different picture. We 898
899 have already seen that HIPCs had worse fi- 899
900 nancial depth than other LDCs. Financial 900
901 depth, which King and Levine (1993a,b) iden- 901
902 tified as a critical determinant of growth, does 902
903 not improve in the HIPCs over time. 903

904 The inflation rate oscillated in the HIPCs 904
905 without any clear trend over 1979–97. The in- 905
906 flation rate was not in the range that (Bruno & 906
907 Easterly, 1998) identified as associated with 907
908 negative growth performance (40% and above), 908
909 although it spent a few years in the 20–40 909
910 danger zone where there is a high risk of slip- 910
911 ping into the above 40% zone (Bruno, 1995). 911

912 HIPCs spent a good part of the debt relief 912
913 period with the black market premium above 913
914 the 20% threshold defined by Sachs and Warner 914
915 (1995) as one of the criteria for being a 915
916 “closed” economy. After a wild period in the 916
917 mid-1980s, however, there is a tendency for 917
918 both the median and variance of the black 918
919 market premium to fall over time in the 919
920 HIPCs.³⁴ 920

921 There is good news and bad news on another 921
922 exchange rate measure, the measure of devia- 922
923 tion of local prices from purchasing power 923

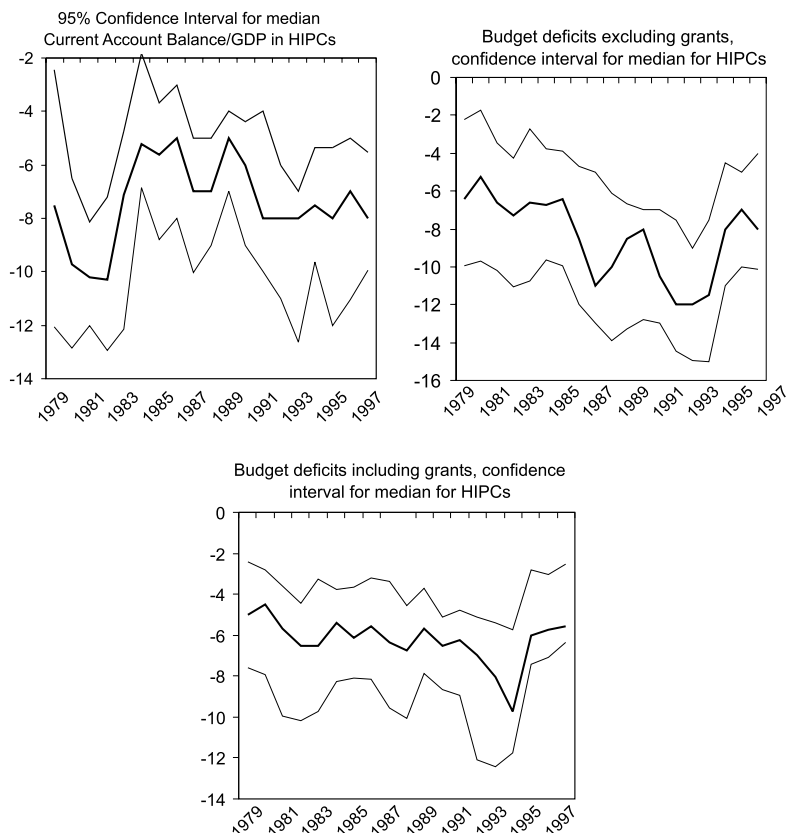


Figure 3. Current account and fiscal balances over time in HICPs.

924 parity at the official exchange rate. I construct
 925 an purchasing power parity index of Dollar
 926 (1992) to benchmark the real exchange rate as
 927 an average of 1976–85 for each country, then
 928 convert it to a time series using the usual defini-
 929 tion of the real exchange rate ($P_{\text{Domestic}}/$
 930 (EP_{US})). The good news is that the real ex-
 931 change rate depreciates over 1979–97 in the
 932 HICPs. This is one of the major achievements
 933 of this 20-year process of adjustment and debt
 934 relief.

935 The bad news is that the initial position was
 936 extreme overvaluation and the improvement
 937 was only gradual, so that the average exchange
 938 rate in the HICPs for the period is severely
 939 overvalued (as we saw in the regression analy-
 940 sis). Another piece of bad news is that other
 941 LDCs also had a tendency toward real depre-
 942 ciation, so that at the end of the period the
 943 HICPs were still 24% overvalued relative to
 944 other LDCs.

The HICPs fared worse on our broadest 945
 measure of policy, the World Bank's subjective 946
 rating called the CPIA.³⁵ The HICPs display 947
 no clear trend over time. This is consistent with 948
 the story that intertemporal preferences were 949
 unchanged before and after debt relief, and the 950
 government used poor policies to impose its 951
 high discount rate on the whole economy. 952

(f) Supply of financing

Figure 5 shows the composition of gross 954
 disbursements to HICPs over 1979–97. The 955
 prediction that private credit would disappear 956
 and multilateral financing assume an increased 957
 share are more than confirmed. World Bank 958
 International Development Association (IDA) 959
 financing alone more than tripled its share in 960
 disbursements. The share of private credit be- 961
 gan the period 3.6 times higher than the IDA 962
 share; by the end of the period, the share of 963

HIPCs AND DEBT RELIEF

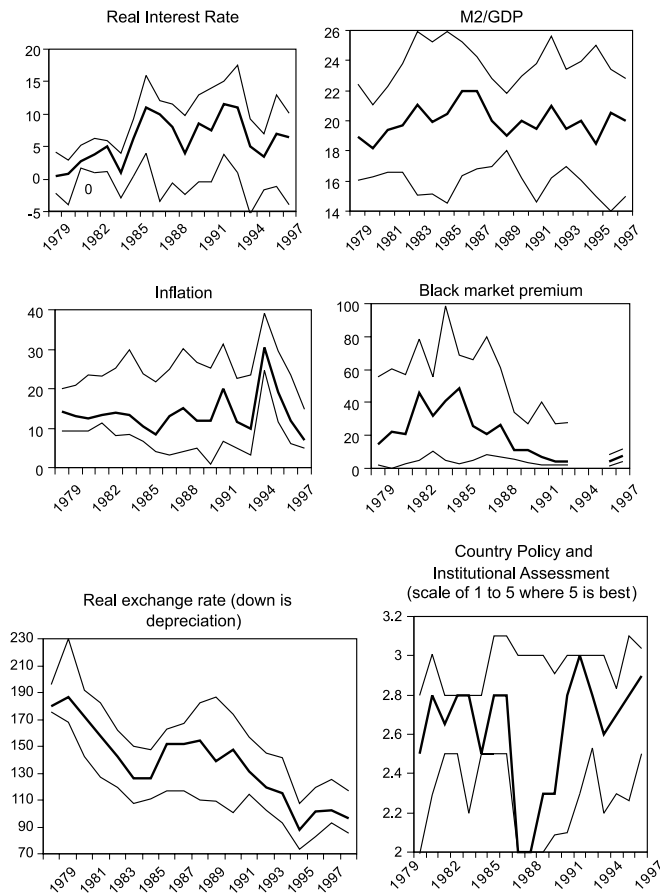


Figure 4. HIPC country policy indicators over time (95% confidence interval for median current account balance/GDP in HIPCs).

964 IDA was 8.6 times higher than that of private
 965 financing. The private credit flows do not take
 966 into account private capital flight, and so
 967 probably understate the degree to which private
 968 capital flows reversed themselves. A recent
 969 study found that Africans held 39% of private
 970 capital outside of the home country during the
 971 period in which Africa's high debt was accu-
 972 mulated (Collier, Hoeffler, & Patillo, 1999).
 973 Similarly, Ajayi (1997) finds that the stock of
 974 accumulated capital flight over 1980–91 was on
 975 average 40% of the external debt outstanding in
 976 the HIPCs, with such extremes as Rwanda
 977 (94.3%), and Kenya (74.4%).

978 The share of IMF financing, which began at
 979 the same level as IDA financing, remained
 980 roughly unchanged. The other important
 981 change is away from bilateral financing in favor

of IDA and other multilateral concessional fi- 982
 nance. 983

Another important thing to examine is net 984
 transfers (net flows minus interest payments). 985
 On debt that carries a market interest rate, 986
 positive net transfers imply that the debt is 987
 growing faster than the interest rate. This im- 988
 plies the debt is unsustainable (if the recipient 989
 continued to borrow to pay the interest and 990
 then some, this would imply the present value 991
 of debt is unbounded). Net transfers from 992
 concessional sources, on the other hand, carry a 993
 large grant element and so do not have the 994
 same implications for debt sustainability; if 995
 anything higher concessional net transfers 996
 should increase the likelihood of sustainability. 997

Figure 6 shows that all the nonconcessional 998
 net transfers were positive, and so contributed 999
 to the rapid growth of debt during 1979–87 1000

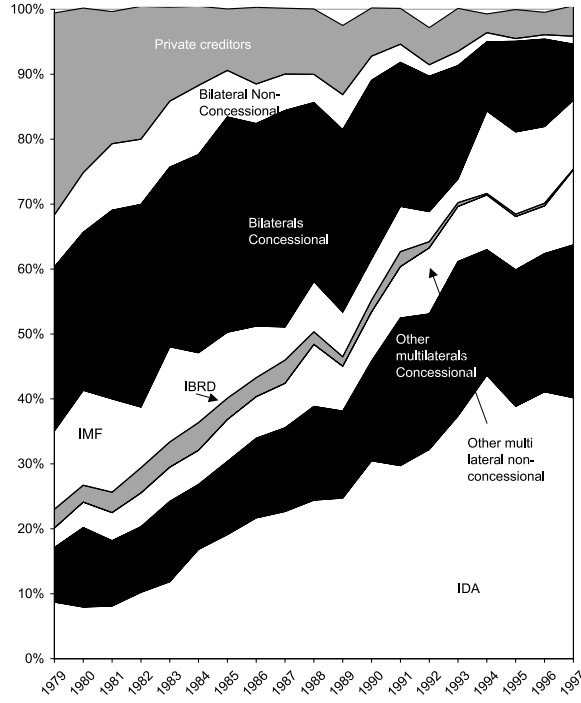


Figure 5. Composition of gross disbursements to HICPs.

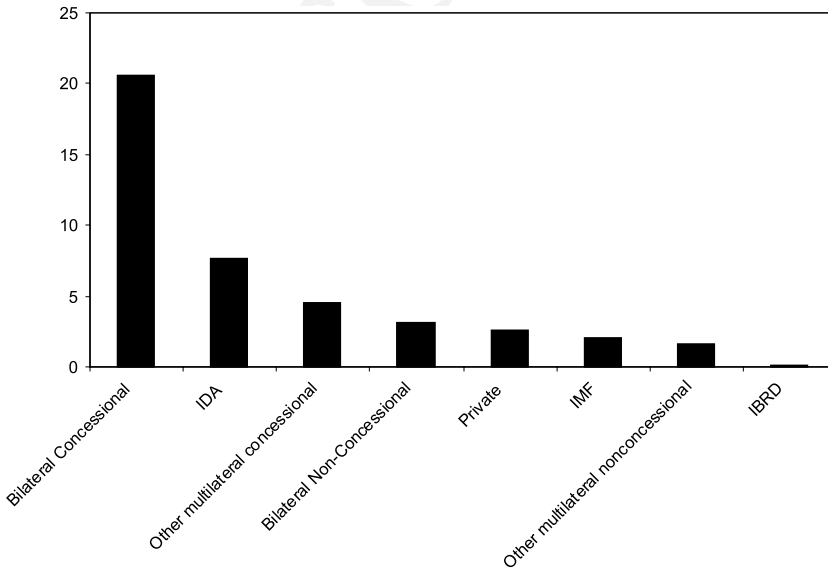


Figure 6. Net transfers to HICPs by creditor, 1979-87 (billion US\$).

1001 (recall Figure 2). But, there were also large net transfers from concessional sources (IDA, other multilaterals, and the bilaterals)—total 1003 net transfers to the HICPs of US\$33 billion— 1004

1005 which makes it all the more striking that these
1006 countries became increasingly highly indebted
1007 in net present value terms over this period.

1008 Figure 7 shows that there was a huge shift in
1009 net transfers from 1979–87 to 1988–97, a period
1010 in which debt ratios stabilized. Large positive
1011 net transfers from IDA and bilateral concessional
1012 sources offset negative net transfers for
1013 IBRD, IMF, bilateral nonconcessional, and
1014 private sources.³⁶ This was another form of
1015 “debt relief,” since it exchanged concessional
1016 debt with a large grant element for noncon-
1017 concessional debt. The net present value of debt
1018 however, remained roughly unchanged over
1019 this period, at least until the last few years,
1020 suggesting that these economies persisted in
1021 “high discount rate behavior.”

1022 This increase in multilateral lending (a good
1023 part of it structural adjustment lending) took
1024 place despite the poor policies noted earlier,
1025 which casts doubt on the wisdom of official
1026 lending that took place. For example, Zambia
1027 received 18 adjustment loans over 1980–99
1028 from the IMF and World Bank but had sharply
1029 negative growth, large current account and
1030 budget deficits, high inflation, a high black
1031 market premium, massive real overvaluation,
1032 and a negative real interest rate for most of that
1033 period. As of the year 2000, when it received a

1034 commitment of debt relief under the HIPC
1035 initiative, Zambia still had high inflation and
1036 high budget deficits.

1037 Côte d’Ivoire got 26 adjustment loans over
1038 1980–99 but had negative growth, high current
1039 account deficits, and an overvalued real ex-
1040 change rate. After the initiation of adjustment
1041 lending, Bolivia had a hyperinflation, negative
1042 real interest rates, and overvaluation. Bolivia
1043 stabilized inflation by 1987, but growth was
1044 poor, real interest rates went from excessively
1045 negative to excessively positive, and overvalu-
1046 ation remained.

1047 A cynical interpretation would be that as
1048 countries could not or would not pay their
1049 nonconcessional debt, official lenders replaced
1050 their nonconcessional debt with concessional
1051 debt that had a large grant element. This
1052 should have significantly eased the debt ser-
1053 vicing burden of the HIPC’s. Even so, the
1054 HIPC’s still had enough of a debt problem at
1055 the end of the period that lenders initiated more
1056 debt relief.

1057 A major motivation of the HIPC Initiative
1058 has been to use the resources freed up by debt
1059 relief to help the poor. It is quite a challenge
1060 however for the HIPC governments to imple-
1061 ment effectively conditions on increasing pov-
1062 erty-reducing spending when they have such a

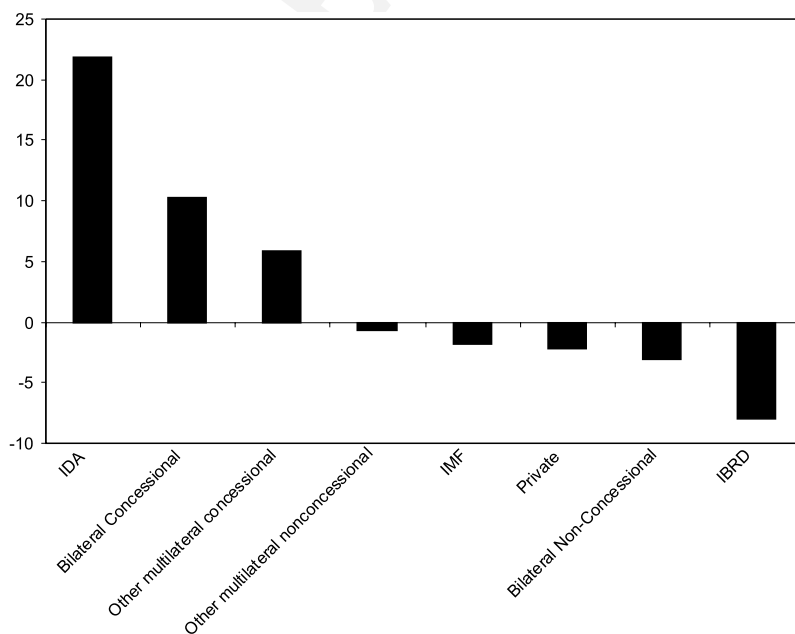


Figure 7. Net transfers to HIPC's by creditor, 1988–97 (billion US\$).

1063 mixed record on conditions on improving
 1064 macroeconomic policies—macropolicies are
 1065 usually considered easier to implement than
 1066 poverty reduction programs. Moreover, the
 1067 data are not to place for governments to even
 1068 know whether spending is reaching the poor. A
 1069 survey in March 2001 found that only two of 25
 1070 of HIPCs would be able to carry out satisfac-
 1071 tory expenditure-tracking systems within one
 1072 year (IMF & IDA, 2001). A year later, in
 1073 March 2002, none of the HIPCs' expenditure
 1074 tracking systems was rated as satisfactory and
 1075 Uganda was the only HIPC to have reported
 1076 actual poverty-reducing spending in fiscal year
 1077 2000/2001 (IMF & IDA, 2002). "Concessionary
 1078 finance used unproductively leads to indebted-
 1079 ness which is then used as an argument for
 1080 further concessionary finance" (Bauer, 1972, p.
 1081 127).

4. CONCLUSIONS

1083 The theoretical concepts in this paper predict
 1084 that governments with unchanged discount
 1085 rates in the long run will respond to debt relief
 1086 by running up new debts or by running down
 1087 assets. There are some signs that the incre-
 1088 mental process of debt relief over the past two
 1089 decades fulfilled these predictions. New bor-
 1090 rowing was correlated with debt relief so that
 1091 debt ratios actually got worse. Per capita out-
 1092 put had a trend decline, suggesting decumula-
 1093 tion of productive assets, broadly defined. Oil
 1094 reserves were depleted more rapidly and sales
 1095 of state enterprises to foreign owners were
 1096 higher in countries that got debt relief.

1097 Policies by which government implicitly or
 1098 explicitly taxes asset accumulation displayed a
 1099 mixed pattern of some gradual policy im-
 1100 provements and some failures to improve. The
 1101 most important policy indicators for heavily
 1102 indebted countries—the current account deficit
 1103 and the budget deficit—failed to improve, and
 1104 they remained above other LDCs' levels con-
 1105 trolling for their initial values in 1979.

1106 There is also some good news. HIPCs' ex-
 1107 change rate overvaluation and black market
 1108 premium improved over time. Debt ratios fell
 1109 in the past three years, and per capita income
 1110 rose. This could indicate that the most recent
 1111 HIPC debt relief initiative has been more suc-
 1112 cessful than earlier debt relief efforts, although
 1113 we have only a few years of data on which to
 1114 draw conclusions. Debt relief at least makes

possible higher consumption in HIPCs, if
 nothing else.

1115
 1116
 1117 Still, the problem of the adverse selection of
 1118 HIPCs remains a serious one. By 1997, with the
 1119 coming of the new multilateral debt relief ini-
 1120 tiative, HIPCs received 63% of the flow of re-
 1121 sources devoted to poor countries despite only
 1122 accounting for 32% of the population of those
 1123 countries.³⁷ Including debt reduction as aid,
 1124 Côte d'Ivoire received 1,276 times more per
 1125 capita aid net flow than India in 1997.³⁸

1126 The results on composition of financing are
 1127 also rather alarming. The HIPCs' debt crisis
 1128 developed because of the expansion of official
 1129 lending. The official lenders did not seem to
 1130 follow the same prudential rules as private
 1131 capital, which pulled out of the HIPCs. The
 1132 IMF and World Bank provided more financing
 1133 to HIPCs over 1979–97 than other countries of
 1134 their income level, despite their worse policies.
 1135 In the second half of the period, positive net
 1136 transfers from IDA and bilateral concessional
 1137 sources offset negative net transfers from
 1138 IBRD, IMF, bilateral nonconcessional and
 1139 private sources.

1140 What are the policy implications? Debt relief
 1141 is futile for governments with unchanged long-
 1142 run preferences (i.e., governments that continue
 1143 to be dominated by rent-seeking elites). At best,
 1144 only governments that display a fundamental
 1145 shift in their development orientation should be
 1146 eligible for debt relief. To assess whether gov-
 1147 ernments have made such a fundamental shift
 1148 in preferences, some track record of develop-
 1149 ment-oriented behavior should be required
 1150 prior to granting debt relief. There were im-
 1151 portant steps in this direction in the 1996 HIPC
 1152 initiative, which unfortunately may have been
 1153 weakened by the 1999 "enhanced HIPC." Of-
 1154 ficial lenders should not keep "filling the fi-
 1155 nancing gap" in violation of prudential
 1156 standards of creditworthiness.

1157 Perhaps what has been most damaging to
 1158 incentives for new borrowing and delayed re-
 1159 forms is the creeping process of debt relief over
 1160 the past 20 years. Although debt relief is done
 1161 in the name of the poor, the poor are worse off
 1162 if debt relief creates incentives to delay reforms
 1163 necessary for growth.

1164 A once-and-for-all program is greatly supe-
 1165 rior to a gradual program of increasing relief.
 1166 The once-and-for-all program has to attempt to
 1167 establish a credible policy that debt relief will
 1168 never again be offered in the future, and that it
 1169 is only giving debt relief to governments with a
 1170 shift in development orientation. If this is

1171 problematic, then the whole idea of debt relief
 1172 is problematic. It results in more resources go-
 1173 ing to countries with bad policies than poor
 1174 countries with good policies. It is ironic that the
 1175 aid community allegedly arrived at the con-
 1176 sensus “aid works in a good policy environ-
 1177 ment” while one of the principal development
 1178 efforts has been a program that selects countries
 1179 based on past *bad* policies.

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 and Rogoff (1996), Ogaki, Ostry, and Reinhart 1182
 (1995) and Winkler (1933). 1183

NOTES

- 1186 1. World Bank (1998a, p. 56). 1216
- 1187 2. Dupuy (1988, p. 116) and Lundahl (1992, p. 39, 41, 1217
 1188 244).
- 1189 3. Dommen (1989) and Wynne (1951, pp. 5–7). 1218
- 1190 4. On September 23, 1999, a delegation including U2’s 1219
 1191 Bono, pop entertainment figures Quincy Jones and Bob 1220
 1192 Geldof, and Jeffrey Sachs met with Pope John Paul II 1221
 1193 on Third World debt relief. For more on Jubilee 2000, 1222
 1194 see the web sites www.jubileeusa.org and www.jubilee
 1195 2000uk.org. 1223
 1224
 1225
 1226
- 1196 5. <http://www.jubilee2000uk.org/main.html>. 1227
- 1197 6. <http://www.jubilee2000uk.org/> In 2001, there was 1228
 1198 also a campaign called “drop the debt,” featured at 1229
 1199 <http://www.dropthedebt.org/home.html>. On June 19, 1230
 1200 2001, the coalition unveiled a controversial ad featuring 1231
 1201 a healthy Western baby breast-feeding from a malnour- 1232
 1202 ished African mother and asked “have not we taken 1233
 1203 enough?” As of April 2002, the “drop the debt” web site 1234
 1204 was no longer operating but the www.jubileeusa.org site 1235
 1205 uses the same slogan. 1236
- 1206 7. *International Herald Tribune*: June 14, 1999, p. 1; 1237
 1207 *Financial Times*: June 21, 1999, p. 3; see also the World 1238
 1208 Bank web site on the HIPC initiative www.world-
 1209 bank.org/hipc. 1239
- 1210 8. *International Herald Tribune*: June 12, 1999, p. 6; see 1240
 1211 also Center for International Development (1999). 1241
- 1212 9. The quote is from UNCTAD (1967, p. 3). 1242
- 1213 10. World Bank (1979, pp. 7–8) UNCTAD (1983, p. 1243
 1214 3). 1244
- 1215 11. World Bank (1981, p. 129). 1245
12. World Bank (1984, p. 46). 1216
13. World Bank (1986, p. 41). 1217
14. World Bank (1991a, p. 176). 1218
15. World Bank (1988a, p. xix). The general literature 1219
 started noticing low-income African debt at about the 1220
 same time. See Greene (1989), Humphreys and Under- 1221
 wood (1989), Husain and Underwood (1991), Lancaster 1222
 and Williamson (1986), Mistry (1988), Nafziger (1993), 1223
 and Parfitt and Riley (1989). For more recent compila- 1224
 tions of analysis, see Iqbal and Kanbur (1997) and 1225
 Brooks *et al.* (1998). 1226
16. World Bank (1988b, p. xxxviii). 1227
17. World Bank (1989, p. 31). 1228
18. World Bank (1990, p. 29). 1229
19. World Bank (1991b, p. 31). 1230
20. World Bank (1993, p. 6). 1231
21. World Bank (1994a, p. 42). 1232
22. Boote, Kilby, Thugge, and Van Trotsenburg (1997, 1233
 p. 126, 129). 1234
23. Other analysts like Roodman (2001) also point out 1235
 that Indonesia, Nigeria, and Pakistan have as good a 1236
 claim to be HIPCs as the official HIPCs according to 1237
 most objective criteria. 1238
24. See Easterly and Levine (1997) on ethnic polariza- 1239
 tion. 1240
25. The consumption path will also shift up by the 1241
 annuity value of the lump-sum transfer implied by debt 1242

- 1243 relief. In a real life example of part of this consumption 1290
 1244 effect, the President of Nicaragua gave workers a half 1291
 1245 day off to celebrate being part of the HIPC program. 1292
- 1246 26. The idea of maintaining a stable external debt to 1293
 1247 GDP ratio as one criterion for current account sustain- 1294
 1248 ability is common in official agencies and in the 1295
 1249 academic literature. See for example, Cohen (1996), 1296
 1250 Dadush, Dhareshwar, and Johannes (1994), Milesi- 1297
 1251 Ferretti and Razin (1996), Roubini and Wachtel 1298
 1252 (1998), Van Wijnbergen, Anand, Chhibber, and Rocha 1299
 1253 (1992), and World Bank (1998a). 1300
- 1254 27. I have treated all assets as domestic capital stock, 1301
 1255 and have not introduced the possibility of foreign assets. 1302
 1256 It is straightforward to extend the definition of A to 1303
 1257 include foreign assets (capital flight). Therefore, the 1304
 1258 country could reduce its accumulation of flight capital 1305
 1259 abroad in response to a reduction in available new 1306
 1260 borrowing. There is ample scope for flight capital to 1307
 1261 adjust at the margin, and flight capital is a major factor 1308
 1262 in HIPCs (see below). Of course, the flight capital is in 1309
 1263 private hands while the debt is public, so there is the 1310
 1264 "transfer problem" of taxing the private sector to pay 1311
 1265 the public debt. 1312
- 1266 28. See the World Bank web site [www.world- 1313](http://www.world-bank.org/hipc)
 1267 [bank.org/hipc](http://www.world-bank.org/hipc). 1314
- 1268 29. The discount rate used is the average LIBOR over 1315
 1269 1979–97. 1316
- 1270 30. Since debt is not in PPP prices, I also use a non- 1317
 1271 PPP measure of output—the World Bank's World 1318
 1272 Development Indicators Atlas method per capita income 1319
 1273 in 1997, and then apply median real per capita growth in 1320
 1274 HIPCs to get the series. The HIPCs' median debt to 1321
 1275 GDP ratio is somewhat lower than that in the World 1322
 1276 Bank's Global Development Finance (50% here com- 1323
 1277 pared to 70% in GDF), because the discount rate I used 1324
 1278 is higher. Nevertheless, the correlation of debt to GDP 1325
 1279 ratios between GDF and mine across the HIPCs is 0.90. 1326
- 1280 31. Unfortunately, these figures are in nominal rather 1327
 1281 than NPV terms. But, since NPV of debt to exports is 1328
 1282 fairly stable over this period, this supports the idea that 1329
 1283 new borrowing replaced forgiven debt. Moreover, the 1330
 1284 relationship between debt relief and new borrowing year 1331
 1285 by year is not contemporaneous. New borrowing is 1332
 1286 concentrated toward the beginning of the period, while 1333
 1287 debt relief is concentrated toward the end of the period. 1334
 1288 One possibility is that the high level of new borrowing 1335
 1289 caused a threshold to be passed that resulted in debt 1336
- relief; this possibility suggests a potentially serious 1290
 problem with moral hazard. Another related possibility 1291
 is that borrowing countries expected progressively more 1292
 favorable terms of debt relief and engaged in pre- 1293
 emptive new borrowing to keep their long-run ratio of 1294
 net worth to GDP unchanged. In this case, debt relief 1295
 was an illusion. Finally, it is possible that the debt relief 1296
 efforts of 1996–97 were more successful than earlier 1297
 efforts. 1298
32. The calculation for this paper that the median debt 1299
 to export ratio in 1997 is 221% is lower than the World 1300
 Bank's Global Development Finance (GDF) estimate of 1301
 278%. Obviously, the present discounted value is sensi- 1302
 tive to the assumption on the discount rate. Still, the 1303
 correlation across HIPCs between the debt to export 1304
 ratios from GDF and those from this paper in 1997 is 1305
 0.78. 1306
33. The war variable was the percent of time at war on 1307
 national territory during 1979–94. 1308
34. Drazen and Easterly (2001) find that inflation and 1309
 the black market premium display a "crisis provokes 1310
 reform" property, whereas the growth rate, the budget 1311
 deficit, and the current account deficit do not. They also 1312
 find that aid is reduced at high levels of inflation and the 1313
 black market premium, while it increases with current 1314
 account deficits and budget deficits. 1315
35. The CPIA has four components, which are Mac- 1316
 roeconomic Management and Sustainability of Re- 1317
 forms, Policies for Sustainable and Equitable Growth, 1318
 Policies for Reducing Inequalities, and Public Sector 1319
 Management. It is available for 1977–98. These results 1320
 should be taken with a grain of salt, not only because of 1321
 the subjective element but also because the methodology 1322
 for the rating has changed over time. 1323
36. IDA is the concessional lending arm of the World 1324
 Bank, while IBRD is the nonconcessional lending part 1325
 of the World Bank. 1326
37. This calculation sums net flows of long-term debt 1327
 and debt stock reductions going to HIPCs and to other 1328
 low income economies, where low income is defined as in 1329
 the World Bank's World Development Indicators. 1330
38. India's low per capita aid receipts represent not 1331
 only its suffering from the adverse selection of aid 1332
 donors, but also from the tendency of large countries to 1333
 receive small amounts of aid per capita. 1334

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