Path dependencies and the case for debt relief

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Introduction

In the debate over debt relief there are basically three camps. There are those who are against, because they think that an amount borrowed is an amount that should be paid back. There are those who are in favour, because they think that the debt burden prevents poor countries from developing. And then there are those, like Larry Diamond, who are in between. They favour some kind of debt relief, but stress that it should be granted only on the condition that developing country governments clean up their act. Instead of taking position in one of these camps immediately, I will evaluate the position of Larry Diamond by taking a broader perspective. This includes broadening the ethical considerations he uses and investigating what a reform of international financial institutions implies for debt relief. This will lead me to a conclusion that is very different from Diamond.

In the debate over debt relief Larry Diamond takes a sensible view that avoids the pitfalls that plague many good-willing but naïve activist proposals for all-out no-strings relief. Diamond proposes to make debt relief conditional on the democratic reform in the debtor countries. The main argument is that it is no good to give a lot of money undemocratic governments that do not care about their populations welfare. “It is like giving a drug addict a wad of money”, Diamond metaphorizes. Dictators supposedly will just stick it where the rest of the government budget went: In the improvements of their car parks or Swiss Bank accounts.

Narrow focus

Diamond is fundamentally correct that good governance by a committed leadership is the single most important factor that determines a countries development. He is also correct that debt policy is a unique opportunity to exert pressure to improve this leadership. However, Diamond has a narrow focus on the problem. In stressing solely the need to reform domestic institutions in developing countries, he forgets the role that international lenders and international financial institutions play and have played in forming the problem. Broadening this focus on two accounts, which I will do in this article, will lead to very different conclusions.

First of all, Diamond focuses on forward-looking ethical principles when assessing unconditional debt relief. In other words, he asks: What are the consequences of granting conditional versus unconditional debt relief? This is a valid and important question, but ethics can force us to look backward as well: Given the Western role in the build-up of debts, what are the Western responsibilities with respect to debt relief? Second, even when we look at the consequences of debt relief, we should not do this in isolation of other debt related policies. In particular, many observers have advocated the reform of the international lending system. As we will see, the resulting proposals have implications for the way debt relief can best be conducted.

Backward looking reasons

Diamond says in his article that unconditional debt relief is morally inspiring…and profoundly flawed. The profound flaws consist in the inability of unconditional debt relief to bring developing country governments on a virtuous democratic path. This is a respectable consequentialist argument. But it is not the end of the story, because we can also use rule-based or deontological arguments and the case will look very different. A rule based argument will generally rely on the premise that only legitimate debts should be repaid. This way of framing the matter leads to the following question: Are the debts that the developing world is saddled with legitimate?

In a recent publication Noreena Hertz (2004) provides evidence that many outstanding debts to developing countries came about under very adverse and suspicious circumstances. The book argues that the current predicament of many countries is in no small part a consequence of the irresponsible and self-interested behaviour of the lenders.

Firstly, many debts were granted by Western governments for strategic reasons during the cold war, regardless of the nature of the regime. Recipients included Saddam Hussein and Mobutu, not exactly beacons of prudence and benevolence towards their own people. This was well-known at the time, but geopolitical considerations (they might have been self-enriching criminals, but they weren't communists) were more important.

Secondly, many loans outstanding today were granted to further the commercial goals of developing nations. A substantial amount of outstanding loans is in the form of export credits: Loans to developing countries, guaranteed by Western governments, that are immediately used to make purchases from Western companies. Often the investments these export credits cover are of a ridiculously inefficient nature. One should read Hertz' book for examples, including numerous loans guaranteeing arms sales to people like Saddam Hussein. I just give one, because it is so good: The Phillipines will pay 170.000 dollars a day until 2018 for a nuclear plant, built with US loans and US materials, that was never used because its security system was already obsolete at construction and because it stands at an earthquake fault line at the foot of a volcano.

It is clear then that these loans were never intended to help poor countries develop. Perhaps this is not a critical argument in itself: After all one could say that a loan is legitimate if both parties voluntarily, and with full information, entered into the contract. There is no "development" involved in this definition. But the argument becomes critical when one considers that the people who now have to pay back this money never enjoyed any benefit at all. In fact, in some cases their kin have been murdered by the arms these loans bought. Moreover, as Hertz forcefully argues, Western lenders knew to what kind of people they were granting these loans. They also knew, or could have known that these loans were not going to be put to productive use. Having said al this Hertz proposes three criteria on loans for them to be illegitimate and therefore subject to relief. First, the regime to which the money was borrowed had no democratic basis. Second, the monies were used in ways inimical to the interests of the population. Third, the lenders knew that the monies would be used in such a way.

Applying these criteria, billions of dollars (Hertz is not very clear about the amounts involved) of outstanding loans are not legitimate at all and should not have to be repaid*regardless of the consequences this will have.* It is very well possible that this will not help the people of developing countries very much, although I personally do believe that it will make a difference. But one cannot

ask them to keep repaying millions of dollars every day that were used, often at their expense, to further Western interest. I cannot here deal with the enormous practical difficulties that accompany an impartial evaluation of debt on the above criteria. The point is merely to show that ethics demands more of us than just looking at the consequences of debt relief.

Reform

I believe the argument outlined above is compelling, but it is not the most pragmatic way to look at the matter. So what happens when we focus on forward looking arguments á la Diamond? As I will explain now, even then there are reasons for granting unconditional debt relief. To see this we need to take a step back and need to look at the landscape of the international debt market.

Let's start by saying that international debt is not evil. It can enable countries to invest much more, and grow more rapidly than they ever could on their own. Compare it to the gains from international trade: Basically a developing country trades some of the high returns on its investment opportunities for the possibility of using advanced countries savings. Both parties can benefit from this if the transaction is well managed.

Unfortunately, the international debt market is anything but well managed. The root of this lies in informational problems of which an outline is given by Max Borders in the *Core concepts*. In short, lenders do not know or care what risk borrowers will take with their money. And since they have almost no way to ensure collateral, they can exert little pressure on borrowers to behave in the way lenders think prudent[1]. Moreover, and apart from the informational problem, we have seen above that regimes can borrow money in the name of a population that they do not represent.

Economists and social scientists have long been investigating ways to make sure that some of the adverse incentives for both lenders and borrowers disappear. In other words, they focus not so much on the developing countries' *domestic* institutions, but on the international lending institutions. The idea is that although the former institutions may ultimately be the most important for developing country growth, international institutions play a large role in shaping them. A particularly clear exposition of what a reformed system should look like is given in chapter 6 of Thomas Pogge's wonderful book "World Poverty and Human Rights"[2]. The basic idea is simple: There should be a committee (Pogge calls this a Democracy Panel) that determines whether a government adheres to democratic principles or not. This Panel should consist of independent jurists, preferably under auspices of the United Nations, and should have the resources to monitor elections and other important developments in participating countries. If it judges a country to be democratic, lenders can expect the population to be held responsible for its debts. If it is not so judged, lenders cannot enforce future repayments from a country's population. Pogge suggests that fledgling democracies should include an amendment in their own constitutions that allows the Democracy Panel to decide, according to certain criteria, whether the loans granted to it should be paid back. An indirect effect of this setup is that it becomes far less attractive to stage coups d'etát, promoting stability in developing countries.

These are the essentials of his plan. Again this essay is too short for the practical details, but. the point that should be taken away is that it is possible to design a financial system where dictators

[1] In this light, it is perhaps surprising that the international debt market exists at all, and some analysts think it might disappear (see for example Shleifer (2003).

[2] A similar idea is developed by the economists Kremer and Jayachandran.

cannot borrow in the name of their country. Such an institutional design is essential if we are to avoid repeating the mistakes that brought us in the current situation.

Reform and relief

Note that there are similarities between this idea and that of Diamond. In both plans money, in the form of debt or debt relief, will flow easier to countries that commit themselves to democratic values. But there is an important difference. Whereas Diamond's proposal uses existing (and remember, partly illegitimate) debt as a lever to exert pressure, Pogge's plan relies on using the carrot of future commitments. This gives Pogge's idea an important edge, because it provides a guarantee that future debt build-ups will be more responsible than those of the past.

Very well, you might say, but why not implement both reforms and have the maximum leverage possible? Get at those dictators in any possible way. But consider what happens if the international community were to do this. Countries that suffer under the rule of dictatorship would indeed be hit twice. First, by decision of the Democracy Panel they would not be eligible for future loans (unless perhaps for prohibitively high interest rates). Second, they don't get any debt relief. Since most third world countries rely on the roll-over (extension) of loans to service their debt, they would be almost certainly not be able to repay their current loans. Countries that are not willing to move towards democracy right at the introduction of the system would therefore declare massive default. The international debt crisis that this will bring is not only bad in itself (the dictators will suffer far less than their populations), but the expectation of such a financial crises could diminish all current enthusiasm for the reform among lenders. Moreover, a debt crisis is not a good way to induce reforms in third world countries themselves. As recent developments in Ecuador show, it will only lead to political chaos.

In short, the existing debts are an obstacle for introducing a new system for international debt management. There are a number of possibilities to get around the massive-crisis problem. One is to give the undemocratic countries some time to start moving, time during which some loans would still be extended to these countries. Alternatively, one could grant them substantial debt relief so that they are not so dependent on future loans to service the existing debt. My preferences lay strongly with the last option. I have two reasons that will conclude my argument for unconditional debt relief. First, granting debt relief while at the same introducing a new system will give a clear message: Let's forget past mistakes from both sides and start again under clear rules. This will take the wind out of the sails of populist leaders with a platform against the international financial community. Second, it stops, as soon as possible, the ongoing practice of credit extensions to dictators that created the whole problem in the first place. Do we want to use the remnants of an old, flawed financial system to exert pressure towards democracy while blocking further advances? Or do we want make offers to institute a new, fair regime, that will exert the same pressure and as a bonus does not allow a repetition of history? To me, these are rhetorical questions.

Conclusion

Our international financial institutions have left us with both an ethical and an economic path dependency. Both lead us to consider unconditional debt relief. Backward looking ethics tell us that

part of the debt outstanding to the third world was meant nor spend in the interest of its inhabitants. Its repayment can therefore not be demanded, and the accompanying relief should be unconditional.

The economic path dependency, created by the existing debt service, consists of third world countries' dependency on international debts. This dependency is an obstacle for the necessary reforms of our international financial institutions. Both reasons make a strong case for unconditional debt relief, especially of the odious debts described in this paper. However, and that is were I put myself in the same camp as Diamond, with this debt relief should come a new financial system that places the responsibility for bad loans where it belongs: On the dictators and the irresponsible lenders of this world.

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