A New Financial Crisis Around the World

In a worsening global economy, forgiving foreign debt of developing countries has become more urgent

By Joseph J. Schatz

After more than 20 years of dictatorship and civil war, the West African republic of Liberia held democratic elections in 2005. That was the good news. The bad news was that Liberia owed nearly $5 billion to foreign countries, international organizations and private creditors — an amount more than eight times greater than its gross domestic product.

Four years later, the country is still wrestling with high unemployment and a life expectancy of just 45 years. But its debt is shrinking rapidly.

In early April, with help from the Treasury Department, the World Bank and European donors, Liberia concluded a deal with a group of hedge funds and other private creditors to buy back $1.2 billion of its commercial debt at just 3 cents on the dollar. That move reduced the country's overall debt burden from about $3 billion in 2008 to just $1.7 billion.

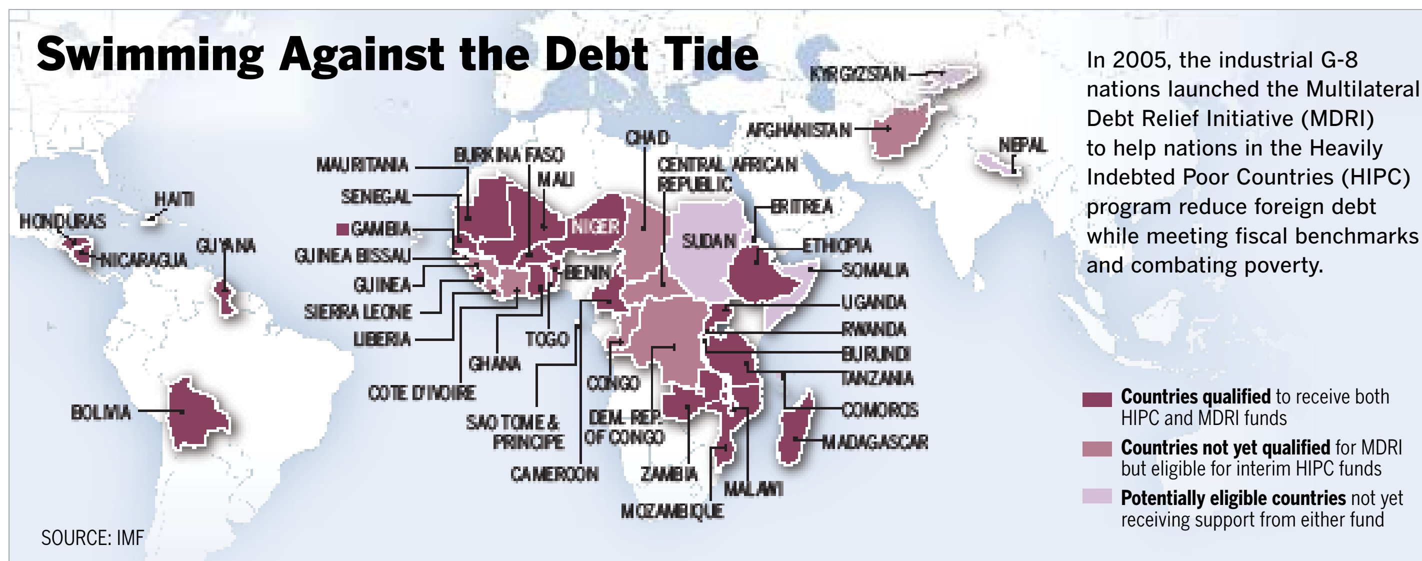
The deal "wipes the slate clean and allows us to look at potential new debt in a more responsible manner," says M. Nathaniel Barnes, Liberia's ambassador to the United States. Barnes says that Liberia's leaders plan to use the money saved from servicing the debt to fund hospitals, clinics, road construction and schools, and ramp up security before its 2011 elections.

The country's creditors went along with the agreement, since most of them had bought its debt on the secondary market at large discounts — meaning that even 3 cents on the dollar may have represented a profit, according to Lee Buchheit, a partner at Cleary Gottlieb Steen & Hamilton LLP, a Manhattan law firm that represented the Liberian government during the negotiations.

The forgiveness of foreign debt in the developing world has long been a celebrity cause, with figures such as U2 frontman Bono leading the charge. But more recently it has evolved into a mainstream economic and foreign assistance strategy by the world's wealthy countries, including the United States. And with credit difficulties assailing economies across the globe, the plight of debt-ridden developing nations has taken on renewed urgency.

No one has yet authoritatively demonstrated whether debt relief programs directly improve governance and poverty rates in the developing world. But they do produce a strong and measurable impact on national budget ledgers. The United States — which administers debt programs through the Treasury Department's Office of International Affairs and via the World Bank and other institutions — has forgiven more than $24 billion in debts since 1991, much of it recently in 20 countries in sub-Saharan Africa. Following these efforts, along with those of other wealthy countries, two-thirds of sub-Saharan African nations now have "low or moderate" debt burdens, according to the International Monetary Fund.

The issue has taken on special urgency in the global financial crisis, with contracting credit markets increasing the likelihood that countries recovering from earlier debt crises



Swimming Against the Debt Tide

In 2005, the industrial G-8 nations launched the Multilateral Debt Relief Initiative (MDRI) to help nations in the Heavily Indebted Poor Countries (HIPC) program reduce foreign debt while meeting fiscal benchmarks and combating poverty.

Countries qualified to receive both HIPC and MDRI funds

Countries not yet qualified for MDRI but eligible for interim HIPC funds

Potentially eligible countries not yet receiving support from either fund

SOURCE: IMF

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could slide back into unmanageable amounts of debt. A recent IMF report warns that for countries across the developing world, "higher borrowing to help offset the impact of the crisis could reverse these gains and pose risks, in particular in countries that are at higher risk of debt distress."

"The financial crisis is putting a lot of pressure on poor countries everywhere," notes Neil Watkins, executive director of Jubilee USA Network, a coalition of religious, charitable and development-oriented organizations that back debt forgiveness efforts. "It's unfortunate because we've actually been making some progress. Ten or 15 years ago, our organization . . . would go lobby the U.S. government or the World Bank or the IMF and they would literally laugh."

A New IMF Mandate

Bound up with efforts to preserve momentum behind existing debt relief initiatives is a move now afoot to overhaul the International Monetary Fund, in part by selling 12.9 million ounces of the institution's gold reserves. Vocal critics such as Nobel Prize-winning economist Joseph Stiglitz argue that the global lender has in the past given ill-advised loans to poor countries — and then compounded the difficulty by weighting them with onerous conditions. With the U.S. eager to use the institution as a tool of restoring global financial stability, emerging economies such as Brazil, China and India are angling for a bigger say in the governance of the IMF, so that its policies will be friendlier to the developing world.

Backers of the idea have powerful allies on both sides of the aisle in Congress, which must approve any overhaul of IMF policies. House Financial Services Chairman Barney Frank, a Massachusetts Democrat, wants to use the gold sale to finance new debt relief efforts for the world's poorest countries. And the ranking Republican on Frank's committee, Spencer Bachus of Alabama, echoes the chairman's concern over the morality of forcing poor nations to pay back debt rather than funding needed social services.

But Jubilee and other advocacy groups say that debt relief efforts thus far have been too restrictive — leaving out many of the poorest nations — and want to make even more countries eligible.

Supporters of broad-based debt cancellation contend that it's an efficient way to assist economies in the developing world — especially in cases such as Liberia, where politically unaccountable dictators racked up enormous amounts of debt. Rich countries find that debt relief is relatively cheap and faster to implement than traditional aid programs — while debtor countries find it affords them greater fiscal flexibility and the means to assert fuller control of their national economies.

But critics contend that expanding debt relief could open the door to debt cancellation for countries with questionable governance or human rights records.

Conversely, some argue, making debt relief too easy to obtain could undermine the positive economic strides that other governments have taken. That's the main reason debt relief legislation — sponsored in the House by Democrat Maxine Waters of California and in the Senate by Democrat Bob Casey of Pennsylvania — failed to make it to the president's desk last year.

Expansion Plans?

So far, the Obama administration has signaled a provisional willingness to expand debt relief efforts. In April, Secretary of State Hillary Rodham Clinton announced that the United States would put $20 million toward reducing Haiti's overall debt burden of $1.4 billion. Clinton and other diplomats had gathered at the Inter-American Development Bank in Washington for a donor's conference for the country, which is still reeling from a series of 2008 Atlantic hurricanes that knocked back its already weak economy. "Their debt obligations further constrain their ability to lay the groundwork for the future," Clinton said. Waters and other debt relief advocates in Congress want the administration to forgive all of Haiti's debt immediately.

For governments, the ultimate goal of debt cancellations is to attract foreign investment. The United States helped bring about that result when it first got into the debt relief business in the 1980s, when policy makers recognized that developing countries in Latin America would be unable to repay the money they had borrowed from international creditors throughout the previous decade.

In 1989, Treasury Secretary Nicholas Brady proposed allowing indebted countries to restructure and reduce their commercial debts. Many U.S. banks strenuously objected to the policy, since it essentially coerced them into forgiving debts held by Latin American countries for strategic political reasons — to quell U.S. fears that major powers such as Venezuela, which already was suffering political rioting over its anemic economy, would succumb to chaos.

But as critics point out, debt relief also has some inherent limits. If a recipient nation lacks effective governance, for example, there's no guarantee that the resources it frees up will be devoted to vital social needs such as education and health care. Nor will a debt relief plan by itself counter deeper weakness in a country's financial institutions or political systems — which prove to be the stronger obstacles to attracting foreign capital over the long term.

Rich countries are increasingly coordinating debt relief efforts to improve oversight. Under the Heavily Indebted Poor Countries initiative, which the IMF launched jointly with the World Bank in 1996, and the Multilateral Debt Relief Initiative, agreed to by the Group of Eight nations in 2005, industrialized nations have agreed to reduce multilateral and bilateral debt in 41 countries by a total of nearly $58 billion.

Nancy Birdsall, president of the Center for Global Development, a Washington think tank focused on development issues, argues that the World Bank and IMF should allow many countries to delay debt-servicing payments until conditions improve in global finances.

"Some of the big projects in infrastructure are being de-funded" in debtor nations, Birdsall said, adding that without assistance, those countries "are not going to be buying anyone's exports."

Still, any proposal to make debt relief more accessible for more countries will face rough going in this Congress. Even though President Obama has stressed his commitment to foreign aid and debt relief as measures to help repair the United States' global image, the acute fiscal crunch in Washington will make it hard to follow through on such promises. That's already the view of Casey, who sponsored last year's Senate debt-relief measure.

But with Congress weighing the proposal to change the IMF's structure and funding — which is now amended to the fiscal 2009 war supplemental bill in the Senate — advocates on the Hill hope they can bring more leverage to bear.

Frank, for example, says that he'll withhold support for the IMF gold sale unless its proceeds go toward debt relief. After all, Frank argues, even though the resources for debt relief may be tightening up, the supply of poor countries that need it is steadily on the rise: "We're in no danger of running out." ■

FOR FURTHER READING: *Fiscal 2009 war supplemental, p. 1162; IMF's changing role, p. 712; U.S. image abroad, 2008 CQ Weekly, p. 2656; Waters debt relief bill, p. 1036.*