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External Debt, Growth and the HIPC Initiative: Is the Country Choice Too Narrow?

Abdur R. Chowdhury

Introduction

The external debt burden of many low- and middle-income developing countries has increased significantly since the 1980s.¹ This prompted the multilateral Paris Club and other official bilateral and commercial creditors to design a framework in 1996 to provide special assistance for heavily indebted poor countries (HIPC) for whom traditional debt relief mechanisms (provided under the Paris Club's Naples terms) are not sufficient.² In return, these countries agreed to pursue IMF- and World Bank-supported adjustment and reform programmes and meet specific policy and performance criteria.

The HIPC Initiative has been considered a major breakthrough mainly due to its key goal of reducing the debt of poor countries to sustainable levels that would allow them to avoid the process of repeated debt rescheduling. As of April 2003, 41 countries, mostly in Africa, have been classified as being eligible for debt relief under the HIPC Initiative (IMF, 2003).³ Of this group, 26 countries have debt relief agreements in place, with relief already flowing in. Two countries (Bolivia and Uganda) have already reached their completion points under the enhanced HIPC Initiative of 1999 (HIPC II), which replaced the original HIPC Initiative of 1996 (HIPC I) (IMF, 2001, 2003).

Nevertheless, major concerns have been raised by policy makers and academics about the capacity of the enhanced HIPC Initiative to provide long-term debt sustainability, mainly because (i) the growth assumption is too optimistic; (ii) debt sustainability analysis is inappropriate; and (iii) country selection is too narrow (Gunter, 2001).⁴ It is the third issue that is the main focus of this chapter.

A large number of studies on external debt have concentrated only on the countries included in the HIPC Initiative (Sachs *et al.*, 1999; Cohen, 2001; Gunter, 2001, 2002; Abrego and Ross, 2002). If our intention is to analyse the overall relationship between debt and growth, then such concentration could lead to a sample selection bias.⁵ Abrego and Ross (2002) have shown that while the overall debt level of the 41 HIPCs tripled from 1980 to 1995, it declined somewhat in the late 1990s. In contrast, the debt level of all developing countries, and even of all low-income countries, continued to rise throughout the same period.

Should the debt retirement initiative thus be limited to the 41 HIPC countries, or should more countries be included under the debt reduction initiative? The answer to this question has important policy implications as a significant number of countries that have been presumed to have a sustainable debt burden also suffer from ever-increasing debt service payments. This has led to a cancellation of many domestic development projects thereby compromising long-term poverty-reducing growth prospects.⁶

This chapter addresses this concern by comparing the impact of foreign indebtedness on economic growth in two separate groups of countries to see if the effect varies across these two groups.⁷ One group consists of countries that are currently eligible to participate in the HIPC Initiative, while the other group consists of severely and moderately indebted countries that have not yet qualified for the HIPC programme. The first group has 35 countries,⁸ the second group 25.⁹

The findings in this study show that the economic malaise due to foreign indebtedness is not limited to the HIPC group. Other low- and middle-income countries suffering from either severe or moderate indebtedness have also experienced a similar adverse effect on long-term economic growth. From the policy perspective, the findings have important implications. If the objective of the debt debate is to enhance the long-term growth prospects of the indebted countries, it may not be enough to limit the debt reduction initiatives only to the 41 HIPC group. Countries outside the HIPC initiative are also finding themselves in a vicious cycle of debt, low growth, poverty and still higher debt. Hence the issue of debt reduction, retirement, or write-off should not be limited to the HIPC group and should be extended to other countries that are in dire need of assistance.¹⁰

Methodologically, the chapter suggests two improvements over the existing studies in this area. First, most of the studies in the cross-sectional debt-growth literature have assumed that observed data are random outcomes of a controlled experiment. However, if the data are

not random draws from a homogeneous population, ignoring heterogeneity among the cross-sectional units will result in biased or meaningless estimates (Balestra and Nerlove, 1966; Hsiao, 1986). In this chapter, following Hsiao *et al.* (1989) and Weinhold (1999), we employ a specification consistent with the dynamic partial adjustment principle. We initially explore the issue of homogeneity across different countries. Initial estimations show a high degree of heterogeneity across countries. Next, we control for the country-specific differences by assuming that the coefficients of country-specific factors are fixed and different while the coefficients of the other variables are random draws from a common population.

Second, most studies in this area consider only a small number of explanatory variables in trying to establish a statistically significant relationship between debt and growth. However, economic theory does not provide a complete specification of which variables are to be held constant when statistical tests are performed on the relation between debt and growth (Cooley and LeRoy, 1981). It is thus likely that many candidate regressions may have an equal theoretical basis, but the coefficient estimates on the debt variable may depend on the conditioning set of information. The study uses a variation of Leamer's (1983) extreme bounds analysis, as suggested in Levine and Renelt (1992), to test the robustness of coefficient estimates to changes in the conditioning set of information.

The chapter is organized as follows. The next section briefly looks at the debt-growth nexus. We then introduce the concept of causality in panel data, and go on to report the results from the causality tests. Findings from the sensitivity analysis are then given and concluding remarks are included in the final section.

The debt-growth nexus and the HIPC Initiative

Worldwide events in the 1970s and 1980s – particularly the oil price shocks, high interest rates and recessions in the developed countries, and then weak primary commodity prices – are usually referred to as the major contributors to the debt explosion in the developing countries (IMF, 2000). A number of studies in the literature have summarized these factors to include, but not limited to, (i) exogenous factors, such as adverse terms of trade shocks; (ii) the absence of sustained adjustment policies, e.g. inadequate progress with structural reform for promoting sustainable growth in exports and output, which gave rise to sizeable financing needs and failed to strengthen the capacity to service debt;