



The impact of the Heavily Indebted Poor Countries initiative on growth and investment in Africa

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ABSTRACT

Between 1996 and 2014, 30 Sub-Saharan African (SSA) countries benefited from debt relief under the Heavily Indebted Poor Countries (HIPC) initiative and the Multilateral Debt Relief Initiative (MDRI). The architects of the HIPC initiative and MDRI posited that these programs would spur growth and investment. This paper exploits the variability of participation in the HIPC initiative and MDRI across time and country, in order to identify the effect of participation on growth and investment. I find that the decision point and post-completion point periods of the enhanced HIPC initiative are associated with a 1.762 percentage point and 3.139 percentage point increase in public investment, respectively. The impact is higher in countries with low access to international capital markets. The enhanced HIPC initiative increases private investment by 1.838 percentage points during the post-completion point period in countries with low access to international capital, for approximately two years, but has no effect on growth or foreign direct investment. I find no effect of the original HIPC initiative or MDRI on growth, private investment, public investment or foreign direct investment. I find no heterogeneous impact of the enhanced HIPC initiative on growth and foreign direct investment by level of indebtedness, access to international capital markets, or institutional quality. As the measures of institutional quality have barely changed between 1996 and 2014 in HIPC countries, the results of this paper suggest that without a strong improvement in institutional quality, debt relief is unlikely to boost investment and growth in Africa. Possible future debt relief in SSA countries should be associated with a component directly aimed at improving institutional quality. If an improvement of institutional quality is not feasible in the short run, debt relief in SSA countries should aim to support public investment.

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1. Introduction

The economies of Sub-Saharan Africa (SSA) have shown strong growth since the mid-1990s. This growth has been particularly robust in the past decade (since 2005), despite setbacks from food and financial crises, political tensions, as well as natural disasters in some African countries (African Development Bank (AfDB), 2014). The main drivers of growth in Africa are primary production and exports, but even non-resource-rich, low-income countries have seen high sustained growth rates. Solid returns on investment have also boosted domestic investment and inward foreign direct investment (IMF, 2013).

Another source of growth may be related to the Heavily Indebted Poor Countries (HIPC) initiative. This initiative was

launched in 1996 by the International Monetary Fund (IMF) and the World Bank.¹ The main aim was to bring poor countries' debt burden to a sustainable level, thereby eliminating "debt overhang," defined as a circumstance in which a country accumulates more debt than it is able to pay (Andrews, Boote, Rizavi, & Singh, 1999). Debt overhang inhibits investment and growth because the government's debt burden imposes an implicit tax on private sector investment (Krugman, 1988; Sachs, 1989).²

¹ To date, 35 countries out of 39 identified as HIPC-eligible have reached completion point and received irrevocable debt relief under the HIPC Initiative and MDRI.

² In addition to debt overhang, theoretical literature linking debt to growth and investment is laid out by the crowding-out theory and the reputational effect theory. The crowding-out theory posits that debt relief will increase growth by freeing government resources that can be used for productive investments (Cohen, 1993). The reputational effect theory stipulates that debt relief does not enhance growth or trigger higher investment, because of the negative impact that debt relief has on a country's reputation in international financial markets, and the uncertainty surrounding future debt service payments (Bulow & Rogoff, 1989).

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The architects of the HIPC initiative posited that the program would spur growth and investment. They drew on theoretical justifications that granting debt relief in the presence of a debt overhang will improve growth and investment (Krugman, 1988; Sachs, 1989). In addition, empirical evidence of the success of the Brady plan for the resolution of the 1980s debt crisis provided additional validation to the theory of debt overhang (Arslanalp & Henry, 2005). However, some authors (Arslanalp & Henry, 2004, 2006; Asiedu, 2003) have argued that, in contrast to the Brady plan, which focused on middle-income developing countries, debt relief through the HIPC initiative was unlikely to stimulate growth and investment. This is because targeted countries lack basic infrastructure (roads, schools, hospitals, and clean water) and institutions (well-defined property rights), prerequisites for profitable economic activity.

Given the ambiguous predictions grounded in valid arguments about the impact of debt relief on growth and investment in the world's poorest countries, whether or not debt relief fostered growth and investment in SSA becomes an empirical question. Moreover, research investigating the effect of debt relief on growth and investment in low-income countries have yielded mixed results (Bandiera, Cuaresma, & Vincelette, 2009; Chauvin & Kraay, 2005; Hepp, 2005; Johansson, 2010; Marcelino & Hakobyan, 2014; Presbitero, 2009). The concern with these studies is that they do not adequately address the problem of self-selection and targeting of debt relief programs. Establishing a causal effect of a debt relief program on growth and investment requires a valid comparison group of countries that did not participate in the debt relief program, constructed using either experimental or quasi-experimental methods.³

In this paper, I examine the causal impact of the HIPC initiative in SSA on four key outcomes related to economic growth. These are, (1) the annual percentage growth rate of gross domestic product per capita (henceforth "growth"), (2) gross fixed capital formation, private sector in percentage of GDP (henceforth "private investment"), (3) gross public investment in percentage of GDP (henceforth "public investment"), and (4) foreign direct investment, net inflows in percentage of GDP (henceforth, "foreign direct investment"). Because participation in the HIPC initiative is not random, I rely on a non-experimental method to evaluate the effects of the HIPC initiative on these four outcomes. Using a sample of 48 sub-Saharan African countries, I exploit the variability in participation in the HIPC initiative across time and countries to identify the causal effect of this participation on economic outcomes. I use a difference-in-differences approach. The key identifying assumption of this approach is that the change in the outcomes of interest in non-HIPC countries is an unbiased estimate of the counterfactual.

I find that the decision point period and the post completion period of the enhanced HIPC initiative is associated with a 1.762 and 3.139 percentage point increase in public investment, respectively. I find no effect of the original HIPC initiative or MDRI on growth, private investment, public investment and foreign direct investment (FDI). The enhanced HIPC initiative increases private investment by 1.838 percentage points during the post-

completion point period for approximately two years.

Furthermore, I find that this limited impact on private investment of the enhanced HIPC initiative only applies in countries which entered the program with low access to international capital markets. However, there is no heterogeneous impact of the enhanced HIPC initiative on private investment by level of indebtedness or level of institutional quality. For public investment, I only find heterogeneous impacts for the level of access to international capital. In particular, I find a higher impact of the enhanced HIPC initiative on public investment in countries with low levels of access to international capital markets. Finally, I find no heterogeneous impacts of the enhanced HIPC initiative on growth and foreign direct investment by level of indebtedness, access to international capital markets, or institutional quality.

In terms of new findings, this paper shows that debt relief, and in this case the HIPC initiative and MDRI, leads to an increase in public investment. Only one study (Cassimon, Van Campenhout, Ferry, & Raffinot, 2015) among prior studies analyzed the effect of debt relief on public investment and finds that debt relief and especially the enhanced HIPC initiative have had a positive impact on public investment. Second, the dynamic effects of the HIPC initiative and MDRI shows that a substantial reduction of debt through MDRI obtained by HIPC countries, can lead to an increase in private investment. This effect is ephemeral however and is limited to about two years. Third, this paper shows that the HIPC initiative and MDRI have no impact of foreign direct investment. Only one study (Presbitero, 2009) among prior research showed this result. Finally, in general, I find no heterogeneous impact of the HIPC initiative on growth, private investment, public investment or foreign direct investment by level of indebtedness or access to international capital markets. None of the previous research has analyzed the heterogeneous impact of debt relief and especially the HIPC initiative and MDRI on growth and investment.

I demonstrate that the results are not biased by preexisting differential trends in growth, private investment, public investment, or foreign direct investment between HIPC countries and non-HIPC countries. I also test the validity of the identification strategy by providing evidence that country participation in the HIPC initiative is uncorrelated with observed time-varying covariates. Finally, I illustrate that these results are robust when controlling for country-specific time trends, change in national leaders, and Naples terms stock of debt relief by Paris Club creditors available to non-HIPC countries. I also show that a sub-group of countries or a particular country does not drive these results.

In addition to assessing whether the HIPC initiative met its core objective of spurring growth and investment, this paper makes four main contributions. First, this paper contributes to the literature of debt relief on growth and investment in low-income countries (Bandiera et al., 2009; Chauvin & Kraay, 2005; Hepp, 2005; Johansson, 2010; Marcelino & Hakobyan, 2014; Presbitero, 2009) and more broadly to the literature of debt overhang for low-income countries (Froot, Scharfstein, & Stein, 1989; Krugman, 1988; Sachs, 1989). In particular, I use the difference-in-difference approach to rigorously test possible impacts of debt relief on growth, private investment, public investment, and foreign direct investment in SSA countries. The difference-in-difference approach is one of the main conventional methods to establish a causal relationship between two variables. Second, contrary to previous studies on debt relief, growth and investment, whose sample includes developing countries as a whole, in this study, I restrict the sample to sub-Saharan African countries to have a more homogenous group. In fact, findings from previous studies on debt relief and growth and investment might mask some heterogeneity due to a higher prevalence in SSA than elsewhere of factors such as weak governance and armed conflicts. These factors can impede the effectiveness of the HIPC initiative

³ The fact that debt relief programs are not random in allocation renders it difficult to estimate the causal impact of debt relief on growth and investment. Countries with extremely high levels of debt and bad economic performance might be more likely to receive it. Therefore, one could find a negative correlation between debt relief and growth, even if it actually improves the prospects of countries that receive it. Of course, it may also be the case that countries with good economic prospects get debt relief, in whose case finding a positive correlation between debt relief and economic performance does not provide evidence that the former causes the latter. Moreover, experimental method includes randomized controlled trials whereas quasi experimental methods include difference-in-differences, matching methods, regression discontinuity design, instrumental variables, and interrupted time series analysis.

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