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# To give or to forgive? Aid versus debt relief

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A B S T R A C T

Is generalized debt relief an effective development strategy, or should assistance be tailored to countries' characteristics? To answer this question, the authors build a simple model in which recipient governments reveal their creditworthiness if donors offer them to choose between aid and debt relief. Since offering such a menu is costly, it is preferred by donors only when the cost of assistance is low, and the probability that an indebted country is creditworthy is high enough. For lower probabilities and higher costs of assistance, donors prefer a policy of only debt relief. Very limited aid is the preferred policy only for high costs of assistance, and low probabilities that the government is creditworthy.

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## 1. Introduction

A main criticism of debt relief initiatives is that developing countries' poor investment performance may reflect governments' preferences rather than debt overhang problems (Easterly, 2002). Were this the case, the impact of debt relief initiatives on long-term growth would be limited. Indeed, if high levels of indebtedness mainly reflect countries' discount factors, then debt forgiveness will just create the conditions for the accumulation of new unsustainable debt, and history will repeat. While we cannot rule out this possibility, it is difficult to believe that no highly indebted government cares about long term growth, and would not invest in worthy projects were its debt canceled.

In our view, the real problem with debt relief is that, while it helps making a country creditworthy, by itself it is not enough. A creditworthy borrower is one which has little debt and is believed to be willing to repay it (good reputation). Unfortunately, generalized debt relief, as it has been conceived, reduces the stock of debt but may not help countries building their own credit history. However, this does not mean that it would not be possible to design alternative debt relief policies so that (private) lenders could

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distinguish the potentially good borrowers from the "serial defaulters." Were this possible, what would be the costs of such policies when compared to policies of generalized debt relief?

In order to answer this important question, in this paper we develop a simple model in which donors do not know debtor governments' discount factors (and thus their willingness to invest) but are allowed to use a menu of official assistance instruments (aid or debt relief) as a screening device. The idea we explore is that low-discount governments value debt relief more than high-discount ones. This means that if they are asked to choose between aid or debt relief, they will choose debt relief (while high-discount ones will prefer aid if the latter is large enough) and the choice will convey precious information about their time preferences, and thus create the conditions for greater market access. On the contrary, a policy that provides debt relief to all countries leads to an inefficient allocation of credit. The reason is that if private lenders cannot distinguish good borrowers from serial defaulters, the amount of loans that the former obtain is lower, and the interest rate higher than if their characteristics were disclosed.

The main message of this paper is that the design of official assistance is important and that the optimal assistance policy depends both upon recipients characteristics and donors' generosity. In particular, we show that the more generous donors and the more patient recipient governments are, the higher are the returns of aid-or-debt relief policies that allow creditworthy governments to signal their type.

The paper is organized as follows. Section 2 briefly reviews the literature on debt relief. Section 3 presents stylized facts on capital market access by countries that received MDRI relief. Our asymmetric information model of development assistance and private lending is introduced in Section 4 and is used in Section 5 to examine the effects of three alternative development policies: generalized full debt relief, the offer between aid or debt relief, and a policy of only aid. Section 6 studies the welfare properties of these three policies. Section 7 discusses partial versus full debt relief. Section 8 focuses on policy implications and Section 9 on robustness. Section 10 concludes.

## 2. Related literature

The existing literature highlights two main channels through which debt relief may affect investment and growth. The first is the resource channel: debt relief reduces debt service payments and this automatically increases investment opportunities in resource constrained countries (Cohen, 1993). The second is the debt overhang channel: debt relief increases the benefits that debtor countries may reap in investing and/or undertaking reform, and thus increase the incentives to pursue such policies (Krugman, 1988; Sachs, 1989; Claessens et al., 1990).

Regarding the first channel, the empirical findings are mixed. On the one hand, Bird and Milne (2003) question the resource constrained assumption arguing that Highly Indebted Poor Countries (HIPCs) serviced their debt out of the loans and grants provided by official donors. On the other hand, although debt service payments are usually not significant in debt-growth equations (Pattillo et al., 2004), there is some evidence suggesting that debt service payments crowd out investment (Chowdhury, 2004; Hansen, 2004). Interestingly, Presbitero (2006) finds that the impact of debt service on investment is stronger than the effect of foreign aid.

Regarding the second channel, the support is much stronger even if results depend very much on the empirical specification, and further work is needed to fully understand the transmission mechanism (Rajan 2005). Existing evidence suggests that debt reduces growth when the debt-to-GDP ratio lies between a "debt overhang" (Pattillo et al., 2004, 2011) and "debt irrelevance" threshold (Cordella et al., 2010). However, these thresholds and even the negative debt-growth relation could hinge on country-specific factors, such as the quality of policies and institutions (Imbs and Ranciere, 2005); and countries with better policies exhibit higher debt overhang and debt irrelevance thresholds than countries that perform less well and for which the negative debt-growth relation is weaker (Cordella et al., 2010).

Very few studies investigate the direct effects of debt relief.[1] Among these Depetris-Chauvin and Kraay (2005), Presbitero (2009), and Johansson (2010) find no significant effect of debt forgiveness

[1] This may reflect the difficulty in properly measuring debt forgiveness.

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