



Giving, forgiving, and taking back: why continue to make soft loans to very poor countries?

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Two key decisions will be needed in coming months on finance for the poorest countries. The first will be whether or not to cancel their outstanding debt. The second, oddly, will be whether to lend them more money. The right answers are to cancel debt, though not at the expense of aid budgets; and to lend more on soft terms to countries that can take them. The main reason for the second choice is that we can't trust aid donors for very long.

The loans in question are mainly from the International Development Association, the soft loan window of the World Bank, and similar facilities operated by regional banks. The IDA currently provides nearly \$8bn per year to the poorest countries, on favourable terms (see box). It holds about a quarter of the debt of the most heavily indebted poor countries, or HIPC's, which owed IDA \$46bn in 2002.

About half of the IDA's income, \$13bn out of the \$23bn it is mobilising in the current three year window, is provided by donors. However, 40 per cent is funded internally, including by repayment of past loans, some of it by countries which have graduated to middle income status, like China and Korea. Moving further over to grants would choke off this flow of repayments.

If debts are genuinely unpayable, they should be cancelled. However,

there are five possible reasons why soft loans should continue to all but the least solvent poor countries. The last is the most persuasive.

First, soft loans help countries graduate from aid to markets. IDA was founded in 1960 on the principle

How the International Development Association (IDA) works

- An international agreement among some 165 governments.
- Part of the World Bank Group, administered by its staff.
- 81 countries eligible for help: they have an income below \$895 per person, poor credit access.
- They get mostly soft loans and some grants, to support growth and reduce poverty.
- IDA is their largest foreign funder of social services like health, education
- It also finances infrastructure, agriculture and general budget support.
- Largest borrowers in 2003: India, Bangladesh, Democratic Republic of the Congo, Uganda, Ethiopia.
- Country funding limits are based on population, income, staff-assessed performance.
- Regular loans are paid back over 40 years including 10 years of grace.
- An administration charge of 0.75% per year is levied in lieu of interest.
- On these terms, 60% of each loan is effectively a grant, and 40% is repaid.
- 1/5 of IDA now provided as outright grants for e.g. post-conflict, high debt cases.
- 23 former IDA borrowers have graduated to harder World Bank terms.
- 35-plus donors replenish IDA funds by donating every three years.
- Donations are based on an agreed distribution key: 70% are from G7 countries.
- Other resources: loan repayments, investments, World Bank net income.

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that developing countries would eventually 'converge' with industrialised countries and be able to tap financial markets directly. Soft loans are a half-way house, building credentials for good financial management. Over time at least some borrowers 'graduate', like China and Korea, and are able to pay their own way.

Unfortunately, many IDA countries have failed to converge, and some are not now solvent even on the softest of terms. For them, grants are indispensable: this is why the current round of IDA negotiations is likely to link future grants to low debt carrying capacity at the country level. At the other end of the scale, near graduation and just beyond it, there are stronger countries that both want and can use more loans than they now receive. Some can afford a somewhat higher price for them. One size does not fit all. There should be more differentiation in funding options, from pure grants through soft loans to market-based terms.

Second, soft loans arguably provide the benefits of 'credit discipline'. Recipients may take more care with loans than outright gifts. Ministries of Finance become involved because loans entail sovereign debt obligations. This brings added scrutiny compared to grants, which need not pass through the treasury, and in some cases are not even notified to the budget authorities. For similar reasons, parliaments tend to be more involved in international debt agreements than in grants.

Third, the more frequently loans are forgiven, the more borrowers come to expect forgiveness, and to manage their affairs accordingly. With systematic conversion to grants, the desired horizon of solvency and market access may constantly recede, as countries are encouraged to overspend. This is an illustration of what economists call 'moral hazard'. There is some statistical evidence for this proposition. However, this argument cuts both ways. If the effect is serious, the genie is presumably well out of the bottle, with recipients of debt cancellation widely expecting future forgiveness. If so, IDA is heading inexorably for grant terms, sooner or later, and drawing more lines in the sand may prove futile.

Fourth, if IDA were to move to grants, this might complicate the division of labour in the overcrowded international aid industry. If IDA became primarily a grant-giving organisation, it could divert funding from, for example, the UN. The UN is subject to directly representative democracy, unlike the multilateral banks, and arguably embodies a partnership ethic in a way the banks, with their conditions-culture and corporate governance, cannot. So it has a strong moral claim for

support. However, it must also prove its ability to manage large-scale resources for development effectively.

These are all plausible but insufficient reasons for continuing to give loans to very poor countries. There is a fifth which carries more weight. This is that we just cannot trust rich country governments – the main fresh contributors to funds like IDA – when they promise to make good any shortfall caused by the loss of repayment income. The flow of repayments recycled through IDA is an undervalued form of South-South solidarity. It also escapes the volatility of budget politics in rich countries. If protected from massive grant conversion and inflation, it could one day make IDA largely independent from donor generosity. Is it sensible to kill the goose that lays these golden eggs? Not, surely, unless we have a better alternative at hand.

The broader argument about 'insulating' development aid from political hiccups and making it more dependable and long-term will surface again and again in 2005. It strikes a chord with anyone who has ever tried to secure durable funding for a development programme. In a world of committed politicians sensitive to global poverty reduction needs, the safety net of a loan window financed partly by developing countries themselves might be thought unnecessary. Indeed, the UK Chancellor's International Financing Facility proposes to deliver bulk finance for poor countries entirely on grant terms, by triggering precisely such long-term commitments from rich countries alone. However, the IFF is not yet assured, as enough donors have not yet stepped forward.

This is then the frontier in the loans and grants debate. Is a large and sustained increase in aid assured? Or is the political constituency for aid still relatively fragile, and likely to remain so, in the US and Japan and elsewhere? If the latter, then the extra cost of maintaining soft loan windows like IDA is a price worth paying.

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