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Towards an MDG-Consistent Debt Sustainability Concept

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Many pledges to increase official development assistance (ODA) remain unfulfilled, and the current economic crisis may constrain such capital flows even further. Can increased debt financing by countries that make progress towards achieving the Millennium Development Goals (MDGs) be justified?

In the spring of 2005, the International Monetary Fund (IMF) and the World Bank implemented a new debt sustainability framework for low-income countries. This policy-based framework seeks to tackle the debt sustainability challenge. According to the framework, countries eligible under the Multilateral Debt Relief Initiative (MDRI) are not supposed to accumulate new debt, even if their debt levels are below the thresholds established in the framework.

Low-income countries are concerned that the framework may lock them into a "low debt-low growth" scenario. Hence the Report of the Secretary-General of the United Nations (UN, 2005: 18) proposed to "redefine debt sustainability as the level of debt that allows a country to achieve the MDGs and reach 2015 without an increase in debt ratios." Following the Secretary-General's proposal, the United Nations has requested suggestions for a conception of debt sustainability that is more consistent with attainment of the MDGs.

Debt cancellation, followed by grant financing for required MDG expenditures, would be the first-best solution. In donor countries, however, there are considerable political constraints on increasing the necessary grant financing. Most of the aid pledged (including the promises made at the G-20 summit in January 2009) is still in the form of loans. While it is not possible to increase the debt financing of development strategies without also increasing indebtedness, it makes sense to provide more loans to countries that can bear more debt.

Gunter, Rahman and Shi (2009) recently provided empirical evidence of a robust relationship between achieving the MDGs and having a greater capacity to bear debt. The study used the same probit regressions used to justify the framework introduced by the Bretton Woods institutions. The finding is that the capacity to bear debt is related to progress made in social development. Even after controlling for good policies and institutions, the capacity to bear debt shows a statistically significant positive relationship with social development.

This allows for the adoption of a new, MDG-consistent debt sustainability framework, which could either add an MDG-progress indicator to the current framework or replace the policy-based indicator with an MDG-progress indicator. The exact composition of the indicator, as well as the next steps to be taken, need further discussion. Our argument is that the new framework has clear advantages.

It should be pointed out that the MDG-consistent debt sustainability concept has some limitations. It will not remove the debt overhang of poor countries that are not eligible for the MDRI and the Heavily Indebted Poor Countries debt relief initiative. The concept is of little use to countries that do not make progress towards achieving the MDGs. Indebting these countries does not provide any solution, since increased debt financing could easily create a debt overhang. This MDG-based concept is not suggested as a mechanism to determine which countries are deserving and undeserving aid recipients. Debt sustainability frameworks and aid allocation frameworks are two different concepts.

Given the above caveats, an MDG-consistent debt sustainability framework has at least four policy implications. First, having a framework with an MDG-progress indicator could increase the nominal amount of total aid provided by donors. This is because increasing aid through loans has lower real costs for donors than providing the same nominal amount of aid in the form of grants. The main policy implication for donors is that they could provide concessional lending beyond the current loan limits.

Second, the proposed new framework would allow countries that make progress towards achieving the MDGs to increase their concessional debt financing. It would also allow them to avoid the costly alternatives of non-concessional financing from domestic and external sources. Third, debt sustainability will be directly linked to the financing of the MDGs, not just good policies and institutions alone. Finally, achievement of the MDGs is measurable more objectively than the policy-based framework introduced by the IMF and the World Bank. All in all, the adoption of an MDG-consistent debt sustainability concept is a win-win solution.

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