

INSIDE:

- An Impressive Step on Paper . . .** 1
- . . . A Smaller Impact on the Ground** 2
- A Longer-Term Impetus for Investment?** 2
- Removing the Debt Overhang** 3
- Returns on Investment in Human Capital** 4

G8 Debt Relief: A Small Step on the Road to a Stronger Africa

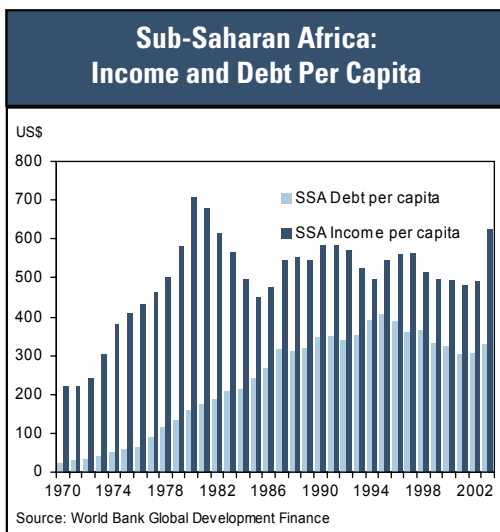
The G8 proposal to eliminate \$40 billion in poor countries' debt is a welcome step for Africa. The impact on the ground is likely to be more limited than the headlines suggest, but it could improve the climate for private investment. Directing the debt savings toward health and education could help raise Africa's productivity growth—the key to its long-term outlook.

Africa is set to play a leading role in the global debate over the next six months, as the UK, which is chairing both the G8 and the EU until yearend, has pledged to make the continent a priority for the international community. International focus on Africa comes at an opportune time. After two decades of disappointing economic growth and declining living standards, sub-Saharan Africa has posted stronger performance in recent years.

While impressive on paper, this debt relief may have a more limited impact on the ground. The cash savings are likely to be small, given that annual debt service in the 14 targeted sub-Saharan African countries is just \$500 million, or one quarter of that region's annual multilateral debt service obligations. Extending the program to cover other major debtors, most notably Nigeria, could significantly increase its impact.

Efforts to promote African development received a boost in June, when G8 finance ministers endorsed a debt relief package that effectively cancels \$40 billion in outstanding multilateral debt obligations for 18 of the world's poorest and most indebted countries, including 14 in sub-Saharan Africa.

Nonetheless, debt relief can help by removing a major economic overhang and by creating a climate more conducive to private investment. It could be most helpful if it encourages local governments to invest more in education and health—two of the major challenges holding back long-term development. Our research suggests that investments in human capital will be the key to labor force and productivity growth—and thus to Africa's long-term economic growth prospects. Applying the savings from debt forgiveness toward spending on health and education could help sub-Saharan Africa to push trend GDP growth from our baseline estimate of 4.9% over the coming decade to as high as 5.6%.



An Impressive Step on Paper...

Ahead of the July 6-8 G8 summit in Scotland, finance ministers of the G8 have proposed cancelling \$40 billion in debt owed to the World Bank, IMF and African Development Bank by 18 highly indebted poor countries (HIPC), including 14 in sub-Saharan Africa

continued on page 2

Goldman Sachs International
 Peterborough Court
 133 Fleet Street
 London EC4A 2BB
 England

Jim O'Neill
 jim.oneill@gs.com
 +44 (0)20 7774 2699

Sandra Lawson
 sandra.lawson@gs.com
 +1 212 902 6821

Roopa Purushothaman
 roopa.purushothaman@gs.com
 +1 212 902 5804

www.gs.com/ceoconfidential

G8 Debt Relief: A Small Step on the Road to a Stronger Africa

continued from page 1

(Benin, Burkina Faso, Ethiopia, Ghana, Madagascar, Mali, Mauritania, Mozambique, Niger, Rwanda, Senegal, Tanzania, Uganda and Zambia). These countries have high debt and low income and, as part of the Highly Indebted Poor Countries (HIPC) program led by the World Bank and IMF, have made significant progress in macroeconomic and poverty-reduction management in recent years. Under the HIPC program, these countries are eligible to have their multilateral debt reduced to 'sustainable' levels (usually defined as no more than 150% of exports).

The G8 proposal goes further by granting 100% relief of (virtually all) multilateral debt for the qualifying countries. This is the first time that the major multilateral creditors have agreed to forgive 100% of the debt owed to them. Thus, with the stroke of a pen, the G8 has effectively achieved the equivalent of two decades of debt relief, considering that these countries have received just over \$2 billion of debt forgiveness each year on average over the past decade.

...A Smaller Impact on the Ground

While the initiative is a welcome start to reducing the debt overhang in these HIPC countries, the impact on the ground will be more limited than the headlines suggest.

Sub-Saharan Africa's debt problem is primarily a holdover from the 1970s, when debt decisions were driven by ideology rather than by sensible analysis of investment risk or development needs. SSA total external debt today (not just that owed to multilateral institutions) is 33 times the level in 1970; in contrast, it has

risen 'only' four-fold since 1980. The region's total external debt is now US\$328 per capita, against income per capita of \$624 and aid per capita of \$34.

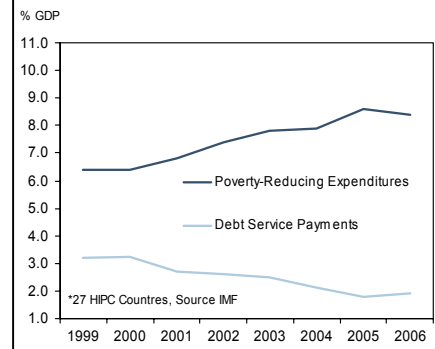
The 14 African countries that qualify for the G8 proposal owe roughly \$36 billion to multilateral institutions, meaning that they will be the primary beneficiaries of the \$40 billion in debt relief. Their annual debt service payments to multilateral institutions, however, have been relatively small—slightly more than \$500 million per year, or just 0.8% of their combined GDP. Nigeria, which does not qualify for HIPC relief, pays nearly as much in annual multilateral debt service.

In fact the 14 SSA countries that do qualify together account for just one quarter of sub-Saharan Africa's total annual multilateral debt service of \$2 billion. Thus while this program is an important start, it is not the end of the story for African debt.

A Longer-Term Impetus for Investment?

After two decades of disappointing economic growth and declining living standards, sub-Saharan Africa has posted stronger performance in recent years. Real GDP growth has averaged 3.8% over the past four years, well ahead of the 3.0% in the prior five and starkly better than the 1.8% seen from 1980-1995. Growth in per capita GDP is also running well ahead of the 1980s and early 1990s. There are ample signs of increased macroeconomic stability, and political stability is improving as well. The New Partnership for Africa's Development (NEPAD), a regional initiative launched in 2001, has brought an increased focus on governance and development.

Poverty-Reducing Expenditures Have Risen As Debt Service Payments Have Fallen*



Our own work, as well as recent independent research on Africa, indicates that the policy environment is critical to growth. Sustainable growth requires political and macroeconomic stability; a sound investment climate; transparency; a robust and well-regulated financial system; and openness to trade and to competitive private markets.

Local ownership of the reform program is also essential. In contrast to previous reform efforts, the G8 initiative is being done in concert with NEPAD and other African-led steps to boost growth. The G8 agreement also focuses on the importance of policies that encourage growth, sustainable development and poverty reduction.

In this way the G8 seek to offer debt relief not just to the poorest or most indebted countries, but to those that are also apt to use the money productively. While it can certainly be argued that the most indebted countries are not necessarily the most deserving of assistance, the HIPC and G8 proposals seem designed to strike

continued on page 3

G8 Debt Relief: A Small Step on the Road to a Stronger Africa

continued from page 2

a balance between helping the ‘worst off’ countries and those most likely to use the money well.

Countries qualifying under the HIPC criteria have already moved to reduce poverty by increasing spending on health care and raising education levels, particularly among girls. Their poverty-reducing expenditure—which includes spending on health, education, basic sanitation and urban and rural development—has risen to 48% of government revenue in 2003 from 41% in 1999, and to 8% of GDP from 6%.

Clearly much more needs to be done, but across a range of governance indicators, the 14 SSA countries slated to receive debt relief score well above the regional average, particularly on measures such as government effectiveness, regulatory quality and control of corruption.

Removing the Debt Overhang

Even if the direct financial impact of debt relief is smaller than the headline figures might suggest, the program is potentially an important step for Africa’s growth prospects. Beyond freeing up resources for future spending, debt relief has important indirect consequences.

By eliminating or at least vastly reducing the debt overhang, it improves the climate for private investment. Debt relief can reduce uncertainty about government finances and macroeconomic stability, result in lower tax burdens and greater clarity about future taxes, and raise productivity by encouraging investors to pursue projects with longer-term returns. Debt relief also frees up government resources that would otherwise be dedicated to negotiations on debt rescheduling.

But does debt relief entail a moral hazard problem that is likely to lead governments into ill-advised

borrowing in the future? By eliminating any future conditionality, are donor governments encouraging or allowing recipients to spend carelessly?

To some extent, only time will tell whether recipient governments are truly committed to implementing growth-enhancing policies, strengthening institutions and improving governance. But the HIPC initiative, which the G8 program extends, has sought to link debt relief to improvements in governance and poverty reduction for nearly a decade. The countries now slated for debt relief are those from the pool of highly indebted poor countries that have done the most to achieve the HIPC goals.

And although donor governments will no longer be able to exercise conditionality over these funds, this will not prevent them from linking future aid to specific development or

continued on page 4

Copyright 2005 The Goldman Sachs Group, Inc. All rights reserved.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of clients of The Goldman Sachs Group, Inc. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice. The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide to future performance. Future returns are not guaranteed, and a loss of original capital may occur. The Goldman Sachs Group, Inc. does not provide tax advice to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment. Certain transactions - including those involving futures, options, and other derivatives as well as non-investment-grade securities - give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only.

We endeavor to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have “long” or “short” positions in, act as principal in, and buy or sell the securities or derivatives (including options) thereof of companies mentioned herein. For purposes of calculating whether The Goldman Sachs Group, Inc. beneficially owns or controls, including having the right to vote for directors, 1% of more of a class of the common equity security of the subject issuer of a research report, The Goldman Sachs Group, Inc. includes all derivatives that, by their terms, give a right to acquire the common equity security within 60 days through the conversion or exercise of a warrant, option, or other right but does not aggregate accounts managed by Goldman Sachs Asset Management. No part of this material may be (i) copied, photocopied, or duplicated in any form by any means or (ii) redistributed without The Goldman Sachs Group, Inc.’s prior written consent.

This material is distributed in the United States by Goldman, Sachs & Co., in Hong Kong by Goldman Sachs (Asia) L.L.C., in Korea by Goldman Sachs (Asia) L.L.C., Seoul Branch, in Japan by Goldman Sachs (Japan) Ltd., in Australia by Goldman Sachs JBWere Pty Ltd. (ABN 21 006 797 897), in New Zealand by Goldman Sachs JBWere (NZ) Ltd., and in Singapore by Goldman Sachs (Singapore) Pte. This material has been issued by The Goldman Sachs Group, Inc. and/or one of its affiliates and has been approved for the purposes of section 21 of the Financial Services and Markets Act 2000 by Goldman Sachs International, which is regulated by the Financial Services Authority, in connection with its distribution in the United Kingdom, and by Goldman Sachs Canada, in connection with its distribution in Canada. Goldman Sachs International and its non-US affiliates may, to the extent permitted under applicable law, have acted on or used this research, to the extent that it relates to non-US issuers, prior to or immediately following its publication. Foreign-currency-denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of, or income derived from, the investment. In addition, investors in securities such as ADRs, the values of which are influenced by foreign currencies, effectively assume currency risk. In addition, options involve risk and are not suitable for all investors. Please ensure that you have read and understood the current options disclosure document before entering into any options transactions.

Further information on any of the securities mentioned in this material may be obtained on request, and for this purpose, persons in Italy should contact Goldman Sachs S.I.M. S.p.A. in Milan or its London branch office at 133 Fleet Street; persons in Hong Kong should contact Goldman Sachs (Asia) L.L.C. at 2 Queen’s Road Central; persons in Australia should contact Goldman Sachs JBWere Pty Ltd. (ABN 21 006 797 897), and persons in New Zealand should contact Goldman Sachs JBWere (NZ) Ltd. Persons who would be categorized as private customers in the United Kingdom, as such term is defined in the rules of the Financial Services Authority, should read this material in conjunction with the last published reports on the companies mentioned herein and should refer to the risk warnings that have been sent to them by Goldman Sachs International. A copy of these risk warnings is available from the offices of Goldman Sachs International on request. A glossary of certain of the financial terms used in this material is also available on request. Derivatives research is not suitable for private customers. Unless governing law permits otherwise, you must contact a Goldman Sachs entity in your home jurisdiction if you want to use our services in effecting a transaction in the securities mentioned in this material.

G8 Debt Relief: A Small Step on the Road to a Stronger Africa

continued from page 3

governance goals. Given the relatively small amount of ‘new’ funds that the G8 program will actually generate for sub-Saharan Africa, this does not appear to be simply ‘free money’ that will encourage poor policy decisions and reckless spending in the future.

As for the moral hazard problem, we do not see the G8 program as akin to the emerging market bailouts of recent years. The key difference is that the creditors themselves—the World Bank and the IMF—are canceling obligations owed to them. They are not ‘bailing out’ private creditors and thus skewing third parties’ risk assessments.

The Returns on Investment in Human Capital

Sub-Saharan Africa still faces significant challenges. We estimate that potential GDP growth for the next decade—what we might expect if

all goes reasonably close to ‘right’—is 5%. This is lower than the 6% we would have estimated for the 1970s and below NEPAD’s objective of 7% per year for the next 15 years.

Our own work analyzes the determinants of long-term growth, in much the same way that we developed 50-year growth projections for the BRICs economies (Brazil, Russia, India and China). Our model measures GDP growth as a function of three factors: growth in employment, growth in capital stock, and technical progress (or the growth in total factor productivity, TFP). Sub-Saharan Africa shows weakness in all three factors.

- Growth in employment is already suffering from declining population growth. The working age population is growing at just 2.4% annually; this is likely to drop to 2.1% in a decade, and to decline further thereafter, as HIV/AIDS and other public health problems take their toll.

- Investment rates are low, averaging 17% in recent years. Our analysis assumes that investment will rise to 22%, extending the recent upturn. This compares to our BRICs estimates, that range from 19% in Brazil to 36% in China. Debt relief could play an important, albeit indirect, role in boosting private investment in much of the region.

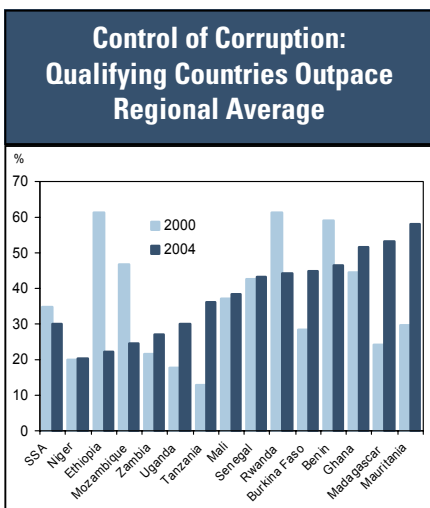
- In general, African TFP growth rates are lower than those for the BRICs economies—in some cases considerably lower—reflecting lower education rates, limited

technological uptake and the economic importance of the relatively unmodernized agricultural sector. TFP has in fact historically been a drag on African growth, rather than the contributor it should be and indeed has been in other regions.

With sub-Saharan Africa (outside South Africa) currently spending less than \$10 billion each year on education and health combined, directing the \$500 million in ‘saved’ debt service toward development programs could have a fairly significant impact. If the current debt relief program were expanded to include Nigeria (worth up to another \$500 million per year) or the rest of sub-Saharan Africa (a further \$1 billion), and if the saved funds were spent on development, then total health and educational spending could rise by as much as 20%.

If Africa did invest its debt savings in human capital development, this could help to boost TFP closer towards the 2% average rate in our baseline projections for the next decade. In fact, if we see sustained improvement, the region may move into the our ‘optimistic’ scenario—one in which growth could average 5.6% over the next decade, against our baseline estimate of 4.9%.

There is much that will need to go right for this rosier outlook to materialize. Debt relief is just the start, and policy decisions will be critical in the years ahead. We hope the latest initiatives prove a further step on the road to a more sustainable growth story for Africa. ■



Source: World Bank Governance Indicators 2005
 * The above chart depicts the percentile rank on each governance indicator. Percentile rank indicates the percentage of countries worldwide that rank below the selected country (subject to margin of error).