Economic development (debt problems and financial crisis of ldc) essay

Business, Accounting

Less develop countries are very sluggish in their economic development since most of the countries are under the mercy of advance or develop countries. Most of the time when calamity strikes they cannot help themselves, However, help from develop countries will be their only option, if not then they will resort to into debt from IMF.

Some developing countries are now thinking of defaulting its debts, when the country’s usable foreign currency reserves plummeted, way below a level sufficient to cover imports. The international community led by the IMF is always to the rescue. This financial crisis is regarded as common of the many difficulties that a developing country has to face. To most people, it appears to have erupted all of a sudden when foreign investors turned their backs on these debt laden country, losing confidence in its economy. A country can be thought of having a problem when the economic indicators are plummeting down. Examples are Gross Domestic Product growth rate, the consumer price inflation, or the current account, or the ratio of current account to GDP, the external debt. This widening current account deficit was sometimes caused by the deceleration of export growth due to the fall in the prices of major export items, Also, it can occur in the series of large corporate insolvencies inevitably undermined the soundness of financial institutions with large exposure to these conglomerates.

Non-performing loans of commercial banks Non-performing loans of the entire financial sector will bring the country to financial crisis. Much more if the leading international credit rating agencies, S; P’s and Moody’s, will downgrade the financial rating. The well known crisis that struck South East

Asia, is the “ Asian currency crisis” that started with the plunge of the Thai baht early in July 1997 quickly spread through the neighboring Southeast Asian region, notably to Indonesia and Malaysia. Causes of the Crisis The Global Poverty Report 2001, which was prepared by the IMF, World Bank, and four regional development banks for the G8 Summit in July 2001, set out an analytical framework to guide the IMF’s and MDBs’ work related to trade and poverty. The report traced several channels through which increased trade openness could affect an economy, particularly including its poor people. These channels include: (1) effects on the prices of goods and services that the poor consume and produce; (2) effects on the demand for and returns to factors of production that the poor can offer, such as labor; (3) effects on government revenue and resources available for anti-poverty programs; (4) the potential for economic growth; and (5) transition costs, including the possibility of increased volatility of growth, resulting in the need for social protection mechanisms.

The report concluded that “ comprehensive trade reform can help reduce poverty when it is part of a set of reforms that improve the domestic macroeconomic and investment climate, enhance infrastructure and technology, and contribute to the provision of knowledge and skills. However, the report cautioned that “ these effects vary significantly across countries, regions, and groups within countries, which makes it difficult to generalize about the effects of trade liberalization on poverty. Less-developing countries will be in debt when its financial resources are less than compared to its needs. To keep up with the globalization, less develop

countries must upgrade its infrastructures and it means big investment where in the world will these infrastructure can outsource, no other than borrowing, mostly to IMF. Not only that, the Government will resort to borrowing to sustain its reputation as a good party. If we will add here the graft and corruption then the incumbent will find ways to find more money for another round of corruption. Much more if there is " population explosion" The government will be in trouble of employment and the demand for the basic commodities will go hay wire. Calamities will also, contribute to the debt of the Less-develop countries.

In conclusion, debt is common among less develop countries and the countries is frozen and will remain in debt. 1. Loss of Market Confidence Caused by Lack of Transparency If one thing had to be pointed out as the primary cause of the financial crisis, it would be the country's loss of confidence in the eyes of international investors, a loss primarily due to inadequate transparency.

First, there was a lack of accounting transparency. The figures which international investors consider most important as basic data when lending to domestic financial institutions or investing in stocks were not reliable, making it difficult to grasp the actual status of firms. In particular, the large conglomerates were composed of many seemingly independent companies which were interlinked through a web of affiliations and cross payment guarantees. Their profits were often overstated by internal transactions among them. In the case of financial institutions, the scale of bad loans was underestimated.

Figures for banks' non-performing loans were announced by supervisory authorities, but they were underestimated by excluding substandard loans, that is, credits covered by collateral on which interest payments are at least six months in arrears. Thus, banks' apparent soundness was based on unreliable figures. Furthermore, the standards for setting aside loan loss provisions were less exacting than the international norm and this resulted in overstatement of banks' profits. No strict examination was carried out on the scale of non-performing loans of the non-bank financial institutions, whose business conditions were no better and often worse than the banks. A low level of overall economic efficiency had become endemic to developing countries as the observance of market principles, which is indispensable in a capitalist economy, was less than complete. Hence, moral hazard was prevalent among almost all economic actors including enterprises, financial institutions, workers and depositors.

Large-scale enterprises, especially those belonging to large conglomerates, had enjoyed a high level of government protection in return for playing the role of locomotive for economic growth. Their domestic markets were often protected by import restrictions, and they were supported by low-cost funding from the financial sector. They were given strong incentives to keep expanding without a careful consideration of the related returns and risks. The principle of too-big-to-fail, typified by the popular expression " conglomerates will never go broke" had been considered an unwritten law. In consequence, the debt-equity ratios of enterprises, especially those of large-scale enterprises rose alarmingly. Weighed down by such abnormal

levels of debt, large enterprises collapsed one after another as the economic downturn became protracted, and a shift of government policy let them go under. Financial institutions also did not properly comply with market principles, having depended on government control and protection over a long period.

The business style of banks was usually to make loans to large enterprises and to those who were able to offer collateral such as real estate, without thoroughly screening their investment plans. As a result, financial institutions contributed to the crisis by failing to prevent firms from wasting resources through inefficient and duplicate investments. The Solutions 1. Macroeconomic Stabilization Policies Developing countries macroeconomic policy is focused on stabilization. This is a prerequisite for expanding foreign reserves, reforming the corporate and financial sectors, and laying a foundation for raising the economy’s medium- and long-term growth potential. Stabilization policies are also essential to safeguard the living standards of low-income earners and the jobless amid the wave of corporate failures and mass lay-offs that inevitably accompanies structural reform. To achieve this, the country has to maintain a tight monetary policy.

In the public sector, a stringent government budget will be allocated. The organization and staff of government agencies are to be slimmed and local government budgets rationalized. Also, the foreign exchange rate will be decided solely by the interplay of market forces. 2. Financial Sector Restructuring Unless ailing financial institutions can be swiftly sorted out from sound ones, confidence in the overall financial system will suffer severe

damage, posing more serious problems. Thus, top priority is being placed on the resolution of unsound financial institutions as promptly as possible. .

Labor Market Reform The dismissal of workers as part of rationalization is now allowed, which eases the rigidities of the labor market. Representatives of labor unions accepted a system allowing lay-offs as part of their contribution toward solving the economic crisis in a consensus achieved by a Tripartite Committee made up of labor, management and government. Legislation was subsequently enacted on the basis of the agreements reached. A Second Tripartite Committee has now been inaugurated. It is reviewing the status of the structural reforms in progress and discussing the matters of concern not dealt with by the first Committee. Conclusion As may be gathered from what has been explained so far, Developing countries has taken wide-ranging measures in order to consolidate the basis for stability, while reforming the overall economic structure and building up the foreign exchange reserves.

Gratifyingly, several bright spots have recently emerged; an improvement in the foreign exchange market, and the stabilization of interest rates. On the other hand, many dark clouds still remain; the credit crunch in the course of financial institutions’ restructuring, negative GDP growth, and rising unemployment. In order for developing countries to surmount the present crisis and regain the momentum of sustained growth, there seems to be no alternative other than swift and intensive structural reform. However, reforms always go hand in hand with pain in the short run.

In the process of putting reform policies into practice, various challenges and dilemmas may well arise. Therefore, a problem we must solve is how to minimize the side effects and pain without wavering from the fundamental thrust of structural reform. To prevent a collapse of production, firms should be provided with sufficient funds. However, in an environment where firms pose high credit risks and financial institutions are liable to merger or closure if they do not meet BIS capital adequacy ratios, the financial community cannot but be extremely cautious in extending credit. The dilemma here is that, in a credit crunch situation, even a sound enterprise may fall victim to a temporary shortage of funds.