

# Case study on different economic concepts

[Technology](#), [Development](#)



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## **How the Developing Market Escaped the Debt Trap**

### 1. 0 Introduction

The debt crisis between the years 2007 and 2008 had huge impacts on the performance of many economies across the world. This saw many industries in such economies collapse while others report very poor performance as a result of lack of funds to invest in them. This is because many people who had funds were afraid of losing their hard-earned money were they to invest it in the various industries. Moreover, people had lost confidence in the financial institutions and were therefore afraid of investing any funds in such sectors for fear of losing their investments. This created a situation where people who needed cash to invest in various business projects could not access these funds because there was very little money in the economy to be lent out. It should however be noted that many of the developing nations did not suffer from this situation as such. This paper therefore examines how the developing market escaped the debt trap.

### 2. 0 The Debt Trap

A debt trap is a situation in which a government's borrowed funds and interest on such loans increases at such a high rate as to pressure on the

government's expenditure which may even force the government to alter the manner in which it conducts its various economic projects. This is a very challenging economic situation to the government concerned because the pressure from lenders may force it to forfeit some of its most important projects. This may cause the government not to achieve its economic goals and objectives which may include but not limited to creation of employment opportunities; increasing access to important services like health among other projects aimed at increasing people's standards of living. Owing to the negative implications of the debt trap, it is very important for any government to avoid getting into this situation as much as possible. During the 2007/2008 global financial crisis, many countries around the world got into very serious debt traps which negatively affected the performance of sectors in these economies. It should however be noted that only a handful of developing nations experienced this debt trap. In the ensuing section, the researcher describes how the developing market escaped this debt trap.

### 3. 0 How the Developing Market Escaped the Debt Trap

It is worth noting that in 1971 for about seventy-five developing nations; the average external debt was less than a quarter of the respective countries' gross domestic product. It is also reported that at that time, less than ten per cent of the developing nations had a debt-GDP ratio exceeding fifty per cent. This was indeed an encouraging economic trend. It was however short-lived because in the 1990, the oil shock drove many of these developing nations into excessive borrowing increasing their external debt to a little more than their respective GDP. At this time the time sixty per cent of the developing nations had a debt-to-GDP ratio being more than fifty per cent. From the

year 2000 this ratio began falling and by the year 2011, it had fallen to about forty-two per cent with less than a third of the developing nations record a debt-to-GDP ratio of more than fifty-per cent. This is a very low compared to the euro zone where the ratio is about 125%. Moreover, among the developing nations, public debt service expressed as a percentage of exports has continuously dropped from eighteen per cent in 1990; to eight per cent in 2000 and finally only three per cent in the year 2011. According to the author of this article, many developing nations were able to escape the debt trap as a result of the reforms that had been instituted in the countries' financial sectors as well as the debt relief extended to them by their lenders. These factors are discussed in the ensuing sections:

### 3. 1 Reforms

The Latin American governments introduced a number of reforms in their financial sector aimed at promoting the stability of the sector thus keeping it strong against any possible shocks as a result of the financial instabilities in other markets across the globe. These reforms included the reducing deficits in the countries' balance of payments; encouraging the reliance on market interests in the operations of various financial transactions as well as through introduction of competitive exchange rates. These measures played a very crucial role in reducing the amount of debt these countries owed other countries and external financial institutions. The reduction of debt was also accompanied with the reduction in the country's expenditure because the amount of interests being charged on the country was reduced as a result of the reduction in the public debt.

Reduction of deficits was a very crucial move because it ensured that each of

these countries was able to import any products from other countries without necessarily having to borrow money to finance such transactions. A country that has large deficits is cannot be any position to import products from another because it may not have adequate foreign currency to make such purchases. This may therefore compel it to borrow such funds thus increasing the amount external debt. If this surpasses the country's gross domestic product, then the country's economic performance would be in jeopardy. This explains why one of the measures taken by these developing nations' government to improve economic performance was to reduce deficits. It was done through controlling the amount of goods being imported by one country from another while at the same increasing the volume of goods being exported.

Another very crucial reform that was undertaken is the move towards market interest rates. These are rates which determine the amount of funds that can be borrowed by an individual or an institution. These rates are very crucial in the sense that they encourage government to borrow funds at competitive rates such that funds can be borrowed even from the domestic market irrespective of the amount. This encouraged many of these developing nations to reduce their level of external borrowing relative to internal borrowing thus cushioning them from any possible financial distress should the external financial markets encounter underperform one reason or another. Since the nations would be having a large amount of funds being borrowed internally, no matter what may happen to external financial markets, the stability of such economies would be guaranteed.

Consequently, this move was very essential as a method aimed at

cushioning the developing nations against the debt trap.

These developing nations also introduced competitive foreign exchange rates. These rates ensured that no one country would dominate foreign trade by setting its foreign currency at a certain exchange value that is discouraging to other nations. As a result of this move, a country could alter its the exchange rate of its currency relative to another country's without any problem. This would then create room for trade to be conducted in a very competitive manner giving a chance to nations: whether developed or developing to participate fully and benefit from the various business transactions taking place.

### 3. 2 Debt Relief

This was one of the reforms that were instituted to enable these countries reduce the amount of public debt. Debt relief was used as an incentive to encourage these developing nations to implement reforms in their financial sector that had been proposed. Multilateral lending institutions introduced the Heavily Indebted Poorest Countries (HIPC) initiative aimed at financially bailing out countries that owed huge debts to the International Monetary Fund and the World Bank. This initiative saw about thirty African countries receive debt relief to tune of over \$ 70 billion. Some of the countries with greater financial challenges received an even larger amount with Liberia and Sao Tome receiving debt relief worth more than the respective country's one year's GDP. This was a very important move because as a result of its implementation, the amount of debt service paid by these poor countries reduced from four per cent of GDP in the years 1999 to about only two per cent in the year 2005. This enabled these countries to have enough funds to

cater for other expenditures and thus avoid wasting all of the country's resources on the payment of the debts. It should be noted that since the implementation of the debt relief program most of these countries economic performance has been reported to improve consistently over the years. For instance the real growth rate of Sao Paulo's gross domestic product was consistently above four per cent up from 1.5 and 3.0 in the years 1999 and 2000. Below is the table showing the country's GDP- real growth rate for the period between the years 1999 and 2011.

This country was able to register this consistent growth in its gross domestic product because of the fact that it had a considerable large amount of resources to use for various economic development projects. These resources had been obtained from the various cost savings that occurred as a result of the debt relief that was offered to the country through the Heavily Indebted Poorest Countries (HIPC) Initiative. This information can also be presented as shown in the chart below:

### **Fig 3. 2 Sao Tome's real growth rate in GDP**

This also played a very crucial role in cushioning the countries against debt traps that would have resulted from the occurrence of the global financial crisis. This is because these countries had already had so many of their public debts settled through the debt relief program and therefore it would not be possible for any multilateral lending institution to deny the country funds on the grounds that the latter had not settled the previous debts. The countries' escape from the impending debt trap was therefore chiefly contributed by the implementation of the debt relief program.

### 3. 3 Strong Economic Performance

Apart from the implementation of reforms and institution of debt relief programs, developing nations have also been able to escape the debt trap as well as a result of an improvement in the performance of the country. This good performance was evidenced with an expansion in the countries' GDP over the years. This increase in GDP enabled the countries to reduce their amount of public debt significantly over the period of time and thus keep the country from being affected by any financial shocks emerging from global financial institutions. This therefore means that no matter what may happen to the global financial markets; the country's financial sector would be secure and stable. Strong performance of the economy is very important because it increases the amount of revenue the raised by the company from various economic activities. These amounts of revenue which may be collected in the form of taxes among other means enable the country to have adequate resources to cater for various public development projects. As a result of this, the country's economic development agencies will be therefore able to finance many of its financial obligations without necessarily having to borrow funds from any external source. This has played a very instrumental role in reducing the amount of debt owed to external financial institutions and therefore enabling the countries escape the debt trap that befell many developed nations

### 4. 0 Conclusion

In conclusion, many developing nations have been able to escape the debt trap as opposed to developed nations because of three main reasons. These reasons include the reforms that were conducted in the countries' financial



sector; the issuing of debt relief to the poorest nations by multilateral lending institutions and the improvement in the performance of these countries' economies. All these factors have been responsible for the countries' escape of the debt trap and therefore especially through enabling the countries to fund their development projects from their own resources internally generated resources s opposed to having t borrow from external lenders. Moreover, as a result of the debt relief, these countries have been able to significantly reduce expenditure on the servicing of debts and hence use it for other development projects. This also reduced the need to borrow funds from external financial institutions thus enabling them escape the dent trap (Kenny, 2013).

### **References:**

Kenny, C., (2013) How the Developing World Escaped the Debt Trap

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