

# The problem of debt burden in hipc countries like tanzania



## **Background to the Study**

The debt burden has been a problem for about three decades now. This has severely impacted negatively most of least developed countries.

Notwithstanding the strides made in changing the economy, most of African countries remain poor and heavily indebted. Tanzania being one of the Highly Indebted Poor Countries (HIPC) categorized for debt relief in the initiative by 2001. In early 2002 the Paris Club VII was signed to provide for the prospects of relief in excess of the promised upon the complete point.

The problem of debt burden can be tracked back in 1970s where a number of macroeconomic stylised facts unveils the problem most of African countries faced. According to Iyoha (1999) this period is regarded as Africa's "Lost Decade" of development opportunities, this is because most of African countries had deteriorated economic conditions. Evidence showed that there was a massive decrease in most of economic performance indicators. In the case of Sub Saharan Africa the GNP per capita decreased at an average rate of 2.2%, private consumption per capita dropped by 14.8%, export volume dropped sharply while the import volume was reducing at an annual rate of 4.3%, terms of trade dropped by 9.1%. On connecting these stylised facts with the real GDP growth rate in most of SSAs the empirical findings shows that, between 1981 and early 1990s the growth rate was at an average of 1.7% which gave about -0.9% in real GDP per capita. Iyoha pointed out further that, the real GDP performance of SSA remained poorly at negative digits until 1995 only when the growth rate became positive at 1.1% this was the poorest compared to the performance by other countries such as in East Asia

where the GDP growth was at an average of 8.0% with China's at an average of 9.2% during the period.

Due to the bad performance of most of African countries, it was inevitable to seek for external finance due to deteriorated economic conditions that made most of internal sources to fail. This forced most of poor countries to accumulated large debts from floating interest-rate loans. A number of factors have contributed to the deterioration of the economy in SSA from political issues, natural disasters to a number economic of shocks that hit different economies in the world.

Carrasco, E et al (2007) pointed out that, one of the shocks is the considerable and unexpected spikes in oil prices and interest rates in the 1970s and 1980s, attached with sharply declined commodity prices, destroyed economies of many developing countries; this is one of external factors that made repayment of foreign debt extremely burdensome. It is believed that the 1970s petrodollar recycling by commercial banks to developing countries lead to the rise of the debt crisis. During that time the price of oil rose giving the oil-exporting countries in the Middle East billions of dollars in profit from a number of US and European banks.

Other external factors that reflects increased hostility of international economic environment includes the decline in the terms of trade; the rise in public expenditure by most of developing countries, this followed the rise in primary commodity prices in early 1970s; the recession in the developed countries coupled with rise in real interest rates; and the rise in protectionism in developing countries.

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Iyoha (1999) pointed out that; internal factors that lead to the debt crisis are connected with the weaknesses of countries' domestic macroeconomic policies which lead to rise in inflation, unemployment level, poor fiscal deficit and capital flight. These factors characterised with bad weather, high population growth leads to a decline per capita welfare of most developing countries in Africa. These adverse shocks were not well absorbed by most developing countries and therefore lead to the rise of debt crisis. In addition most of the developing countries were faced by other political instability, domestic conflicts, and civil wars.

The rise of the crisis brought a grown concern by researchers about the extent of accumulation of external debt stock and its impact on economic growth and development. It is in this light that the grown concern leads to a number of initiatives such as the HIPC's by IMF and the World Bank. The initiative intended to help the highly indebted poor country majority of which are in SSAs to reduce the adverse effects of the overgrown debt burden.

The SSA external debt which was around US\$ 84. 10 billion in 1980 rose to about US\$165 billion in 1988 and US\$190. 21 billion in 1990. According to the World Bank data by 1995, the total SSA's external debt stock amounted to US\$223. 298 billion (Iyoha. 1999). According to him the main problem was on macroeconomic management of most Sub-Sahara African countries of 1980s in responding to the structural adjustment programmes (SAPs) designed to by IMF and World Bank to curb the economic crisis.

With the help of the HIPC's initiative in suggesting policy reform before and after a country initiated into the scheme the SSA's external debt dropped to

40 percent of GDP in 2007 with a good trend in real GDP growth of 6.6% (IMF Economic Outlook, 2008) for three consecutive years compared to that recorded in 1995 at 1.1%. This good trend recorded is mainly attributed to both positive external developments such as aids; debt relief and restructuring; high foreign demand of commodities; and strong domestic investment and productivity gains. Sound economic policies also played an important role in achieving the results in most countries.

Like other Sub-Saharan African countries, Tanzania accumulated a large amount of external debt in the early 1970s. Available data shows Tanzania's external debt has been fluctuating during the period to 2000, enjoying a period of slightly drop and rise of the debts. The 1961 independence and 1978 Tanzania - Uganda war made the country seek for external assistance and debt an inevitable option in helping the country in structuring its economy and social development, this gave rise to the huge debt accumulation. In 2007 the total external debt amounted to US\$5.063 billion, a drop from US\$6.91 billion in 1997 (UN data 2010). However, IMF and World Bank were under attack of critics for its lending policies. It was criticised for its odious and illegitimate lending to Africa. For example, Tanzania owed the World Bank over \$575 million for 26 failed agricultural projects (Carrasco, E. 2007).

Significant efforts have been taken by the government of Tanzania since then to control development programmes in the macroeconomic management. Starting from the 1990s macroeconomic performance has been improving as compared to the late 1980s. For the period of five years to 2000 the real GDP has grown at an average rate of 4.1% equivalent to a modest per capita income growth rate of 1.4% (Bigsten, A. 2001).

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This has been possible with the help of HIPC's and other initiatives in debt relief and forgiveness.

With the rising concern of academics in the growth impact of debt relief and/or forgiveness, I am going to study the same specific to Tanzania observing that, worse have happened but still it was possible for the country to hold up and improve the economy compared to the situation in 1980s.

## **Statement of the Problem**

In understanding the macroeconomic effect of government's fiscal deficit the savings-investment or country's aggregate resources constraint play a key role in showing how public deficit is financed using the scarce resources available both private and through the rest of the world. A country can finance its activities by internally generated revenue from tax collection and other sources. On the overhand when the internal generated revenue is not enough to a country can seek for assistance from foreign country. This may take a form of financial assistance or external debt.

One among other big problems faced by most Sub-Saharan African countries is the problem of high budget deficit with low internally generated revenue to finance the deficit. This has resulted to huge debt problem in most SSAs, Tanzania being one of them it was not spared on the problem. The amounts of the external debt, the servicing requirement of the debt, and the overall burden of the debt stock has not just lead to capital flight and discourage of investment but also increases risk of failure to a number of adjustment programmes designed to rescue the country from the problem.

This has brought a concern about countries' ability to grow fast enough to take the pace of debt service obligations while increase and encouraging domestic investments. Ayaji (1991) pointed out that, the debt management has a terrible impact on countries' economy, this is because, to have a positive impact debt has to be at a certain manageable level beyond which no positive impact will be sought.

The question is what is a manageable level of external debt that we should expect it to have a positive impact on country's economy? In trying to answer this question and according to debt theory a number of initiative have been put in place from interest rate relief proposed on June, 1987 at the G-7 summit in Venice to initiation of HIPC in 1996.

The denomination of external debt in foreign currency creates a big problem to the debtor country; this is because since most of African countries have depreciating currency against other currencies such as US dollar this means the real value of the debt-service will always be anticipated to increase. For example in Tanzania the US dollar have been appreciating from 900TZS/US\$ in 1990s to about 1300TZS/US\$ in 2009, this is like 50% appreciation of US dollar. Therefore in this kind of situation the problem is how does this repayment affect economic growth of a country like Tanzania in a long run?

Theory shows that there are two transmission mechanism through which external debt may be expected to affect economic growth; first the debt service repayment may create the crowding out effect on country's investment by resources transfer out of the country in terms of interest and principal repayment, secondly large debt above the threshold may outcrop

(overhang) and discourage private investment through the anticipation of increased taxes to finance the debt service. Therefore it is anticipated that, if a country can service its debts regularly and if the funds are invested in projects with high return compared to the cost of the foreign debt. A country with these qualities if given debt relief then, then it is anticipated that economic growth and country's welfare will be a reality and not a dream. However, this will be possible if government can control economy and reduce corruption so that the funds will be used in positive profitable projects that will develop infrastructure, schools, hospitals just to mention a few.

## **Objectives of the Study**

The main aim of the study is to provide an analysis of the external debt service capacity faced by Tanzania, and its impact on economic growth. To achieve the main objective the following specific objectives have been designed.

To evaluate the macroeconomic performance of Tanzanian Economy

To analyse the impact of external debt on economic growth and finally to draw policy implications for macroeconomic management.

To analyse the extent to which debt relief/forgiveness helps in boosting economic growth.

## **Significance of the study**

This study is important in that, the knowledge on the extent of the impact of external debt on economic growth is vital policies evaluations of lending and



debt relief/forgiveness to the highly indebted poor countries and the rest of the world. This will also facilitate the trickle-down effect of sound macro-economic policies for implementation at micro-economic levels. This will help the multinational lenders to rethink the debt relief policies and it's significant in growth.

Finally, this study is also expected to contribute to knowledge by providing a better understanding of the relations between external debt and economic growth, and the impact of debt relief/forgiveness on country's long term growth.

## **Organisation of the Study**

Apart from Chapter 1, Chapter 2 gives an overview of Tanzania's macroeconomic performance, while Chapter 3 reviews the theoretical and empirical literature on external debt and economic growth. The methodology is described in Chapter 4. The empirical analysis is presented in Chapter 5, while conclusions, policy implications and suggestions for future research are presented in chapter 6.

### CHAPTER TWO

#### MACROECONOMIC PERFORMANCE IN TANZANIA

### CHAPTER THREE

#### LITERATURE REVIEW

#### THEORETICAL LITERATURE REVIEW

## **Growth and Debt Theories**

Basically in economic literature we learn two ways in which a country can grow its economy. It can be growth which has been brought about by innovations in the process of competition, which can well be described by the dynamic completion model (Ellig, 2001). On the other hand according to Solow (1956) neoclassical model economic growth can be achieved by an expansion in the amount of investment. According to this model a country will attain economic growth if it increases its savings and investments. This automatically implies that for the least developed countries to grow economically they need to implement policies that support greater savings that will then increase investment and hence growth.

To finance its activities a country has a number of options of raising the funds. It can make use of the internal sources such as taxes and fees or it can borrow if the internal source is not enough to finance the budget deficit. According to Adegbite, E et al (2008) the Dual Gap theory is a better explanation of the reason for opting for external finance as opposed to domestic financing in financing the sustainable development. According to the theory in developing countries the level of domestic savings is not sufficient to finance the needed investment to ensure economic development; since investment is a function of savings it is logical to require the use of complementary external goods and services. However, the relationship between domestic savings and foreign funds gives a guide as to how a country can borrow abroad (ibid). Also since most of LDCs are far from their steady state growth any investment injection could lead then to have accelerated economic growth.

The country should borrow abroad if it is anticipated that the return on the borrowed funds will be higher than the cost, therefore we do expect a country to invest in projects having expected returns higher than the cost of foreign debt. Since if not used wisely, debt can amount to impeding the long term growth prospect of the country. External debt does not transform automatically into debt burden when a country optimally make use of the fund.

According to Adegbite et al (2008) in an optimal condition, the marginal return on investment is greater than or equal to the cost of borrowing, in this case debt will show a positive impact on growth.

According to the neoclassical growth theory, debt has a positive direct effect on economic growth. This is because the amount borrowed if used optimally it is anticipated to increase investment. On the other hand the indirect effect of debts is its effect on investment. The transmission mechanism through which the debt affects growth is its reduction on the resources available for investment by debt servicing. According to debt overhang hypothesis, a certain level of external debt has a direct positive effect to economic growth until a certain point where by an additional debt will have a negative effect to growth.

### **The Debt Overhang Theory**

According to Krugman (1988), the debt overhang theory shows that if there is some likelihood that in the future debt will be larger than the country's repayment ability; expected debt-service costs will discourage further domestic and foreign investment because the expected rate of return from

the productive investment projects will be very low to support the economy as the significant portion of any subsequent economic progress will accrue to the creditor country. This eventually will further reduce both domestic and foreign investments and hence downsizes economic growth (Krugman, 1988, Sachs, 1989).

Claessens and Diwan (1990) argue that “ debt overhang is a situation in which the illiquidity effect, the disincentive effect, or both effects are strong enough to discourage growth in the absence of concessions by creditors”. This is a “ narrow” definition of the debt overhang where the impact of a high external debt that is linked to the tax disincentives argument, where any success in indebted country’s economic performance is taxed away by creditors and ultimately little is left over for domestic investment and subsequent growth (Hjertholm, 2001).

According to Were, M (2001) debt overhang has a big effect on external debt, the effect is not just on the physical investment but also the activities associated by all costs to be incurred in the process of increasing country’s productivity in the future. This includes investments in health and education in order to develop human capital, country’s technology just to mention a few. These investments are expected to have a greater impact on growth.

As stressed out by Agenore and Montiel (1996), the approach to external debt is motivated by several observations. Most of which policy-oriented discussion of the debt problem were centered on the question of whether the debt crisis was one of solvency or of liquidity problem.

Differentiating the two terms we can see that, liquidity problem is the inability of a country to service its debts as they fall due. That means lack of liquidity occurs when a county does not have enough cash on hand to pay current obligations. On the other hand, solvency issue relates to whether the value of a country's liabilities exceeds the ability to pay at any time; a country is insolvent when it is incapable of servicing its debt in the long run (Ajayi, 1991).

Taking this into consideration, we observe that, most of least developed countries were solvent and still they are solvent. As pointed out by Kletzer (1988), the present value of the most of least developed countries prospective resources which were measured by discounted value of the real outflows was way far larger than the debt obligations they have.

In answering the question as to why the indebted poor countries had a problem of illiquidity, Jonse G. Leta (2010) in his research on external debt and economic growth in Ethiopia pointed out that although the indebted poor countries have been able to pay i. e. solvent, the willingness to pay decline for a variety of reasons. Among many factors there are domestic and external factors that responsible for this outcome of crisis. The domestic factors often cited include wrong macroeconomic policies such as fiscal irresponsibility and exchange rate misalignment, policies that deter savings such as negative real interest rates, which in turn reduce investment and encourage capital flight and financing long-run projects with short-term credits. External factors include oil shocks, deterioration in the terms of trade and rising foreign interest rates.

Essentially the higher the stock of debt to the country, the higher is the current sacrifice for the sake of the future growth. The theory of debt overhang is well explained by the hypothesis of Debt Laffer curve which relates the magnitude of country's debt and the value of repayment. According to Freytag, A et al (2009) the NPV of the debt repayments increases with stock of debt up to a certain threshold point beyond which a higher face value of the debt will be associated with lower efforts and investments, lower economic growth and lower NPV of expected debt service.

According to Clements, B et al (2005) high level of debt can slow down economic growth in low-income countries, it slows growth only when the face value of the debt reaches a maximum level estimated to be around 50 percent of GDP (or, in NPV terms, 20-25 percent of GDP). Debt overhang depresses growth by increasing private investor's uncertainty about governmental action taken to meet the debt service obligations. These include increase in money supply that causes inflation, distortion of future tax policies (Clements et al, 2005). Therefore the debt overhang problem is linked to the transfer of resources from capital scarce to capital surplus countries.

The debt Laffer curve argument (which was apparently introduced by Jeffrey Sachs) is derived from the tax laffer curve hypothesis introduced by Arthur Laffer, who argues that if personal tax rates were raised, they generate a dreadful impact on government tax revenue. The reason is that high tax rates either simply discourages investment or leads to tax evasion. Figure 1

presents the Debt Laffer Curve of external debt, expected payments and amortizations.

Source: Flores, Fullerton, Olivas (2007).

If the stock of external debt is small, such that from the origin to point 'A', then it is expected that the debtor country will be able to meet the forthcoming debt repayment in full without a problem. Under this situation the marginal expected debt repayment with relation to the debt stock is one. However, after this point the expected debt repayment expands at a lower rate in relation to the debt accumulation. A country under this level of debt stock is expected to have some difficulties in meeting the debt repayment; this can be seen from the marginal expected debt repayment of between 0 and 1 exclusive. The risk of inability to service the debt increases with the increase in debt stock. The risk may vary from country to country according to the level of their debt's interest rate.

At point B, the expected debt repayment reaches its maximum saturated point and then starts falling, at this point and beyond the marginal impact of debt is negative. A country under this situation is totally unable to service the debts and most of the time declared to be in debt crisis.

On extending the debt laffer curve to show the contribution of external debt on economic growth on a country we can have figure 2 below. This shows the non linear relationship of external debt and economic growth as supported by Pattillo, C. et al (2002).. A reasonable level of external debt actually has a positive impact on economic growth while excessive debt

stock is destructive. As debt stock increases with time growth decreases and it can sometimes reaches a negative level of economic growth.

Combining the two figures we have figure 3. Here we can see that as debt increases, creditors' expectations of being paid are distorted. From the figure it is easily seen that when the expected payment of the debt increases proportionally less than the debt stock, the distortions are such that extra amounts of debt start decelerating the GDP growth rate. Moreover, if the debt accumulation achieves higher levels such that the debtor starts diminishing or failing to make its regular amortizations, any extra debt increment will be translated into negative contributions to the GDP growth rate.

Claessens et al, (1996) stressed out that, the other channels through which the service of a large amount of external debt obligations can affect economic performance include the 'crowding out' effect, the lack of access to international financial markets and the effects of the stock of debt on the general level of uncertainty in the economy.

The crowding out effect occurs when there is a reduction in the current debt service that lead to an increase in current investment for an amount of given level of future borrowing (Cohen, 1993). If a country uses greater portion of its export revenue in servicing the debt, very little will be available for investment and growth. Claessens et al (1996) also argues that where foreign assistance is related to the debt and debt service of indebted poor countries, the effects of a debt overhang on economic performance is a more complex question. In ability of a country to service its debts may lead to a



deterioration of relations with creditors, thus reducing the amount of future finances indebted poor countries can access (Khan and Villaneuva, 1991).

## **Theoretical Consideration of Impact of Debt Relief**

From the literature on debt overhang and its effects on growth it is evident that debt relief might have a stimulating effect on investment and economic growth. Since debt overhang exist when a country exceeds its repayment ability, it can be suggested that, expected debt service is an increasing function of country's output level (Krugmanv1988; Sachs 1989). Therefore in presence of debt overhang, the greater percentage of benefits of an increased output brought about the debt accrues to the creditor while all the costs incurred accrue to the indebted country.

The incentive mechanism suggests that, in the presence of debt overhang high debt reduces both public and private investment. In the case of public investment, the incentive to investment is discouraged when a large percentage of the return on the debt accrues to the creditor (Johansson 2010). According to Helpman (1989) the disincentive to private investment occur when a high future debt service acts as implicit tax because more will have to be raised out of the tax to help finance the debt obligations. In this situation projects with quick return will be preferred to long term because there will be high uncertainty on government actions and its policies in meeting the debt obligations (Servèn 1997).

High level debt increase government's disincentive to carry out reforms. As supported by Johansson (2010) that high level of debt makes economic reforms less advantageous and slows down growth because in the presence

of debt overhang the growth-enhancing reforms intensify the pressure to repay foreign creditors than fuelling the growth and improving social services.

Therefore when a country suffers from debt overhang, debt relief has the potential to improve economic efficiency. This can be possible by reducing the debt stock; the reduction will then spill-over its effects and reduce the debt overhang. This will then prevent the disincentive suggested.

Cohen (1993) suggested that, debt service payments crowd out investments in areas such as education, health and infrastructure development which are direct as well as indirect impact on economic growth. To help in facilitating growth debt relief frees resources which were tied up in debt servicing enabling government to reallocate the freed resources to more productive areas. Looking into resource mechanism in detail it is evident that not just debt relief might bring about the growth due to the freed resources but other factors such as the magnitude of the relief or forgiveness, government investment decisions of the freed resources, revenue collection, new borrowing, and aids have impact on growth. As supported by Cassimon et al (2008) that since the creditors give debt relief to countries facing repayment difficulties, the resource mechanism might not create a greater fiscal space to help investment.

The impact of debt relief or forgiveness on growth might be limited due to moral hazard or adverse selection (Johansson, 2010). This is because with the idea that the debt will be forgiven or relieved in future, borrowers will be encourage to take up excessive amounts of new loans, expecting that it will

be forgiven when the country is in repayment difficulties (Easterly, 2002).

This will push countries to rise up new loans even if there are no productive investment opportunities.

In adverse selection case, creditors give relief to countries which face payment difficulties and not the ones that are willing and able to increase their investment. A country in this situation might be faced by factors such as profligate government, political instability or interest group polarization reflecting the high discounting toward the future (Easterly, 2002).

He pointed out further, for the debt relief to have a positive impact on growth, good institution and governance is inevitable. This was also supported by Rodrik, D et al (2004) because countries with better institutions and government invest more in physical and human capital and make efficient use of the resources to achieve higher growth. In absence of good institutions and governance the freed resources would not translate to productive investments.

## **Empirical Literature Review**

### **Debt overhang, investment and Growth**

Milton Iyoha (1999) used macroeconometric model to facilitate the simulation of the impact of external debt in economic growth in Sub-Saharan Africa. With the use of simultaneous equation models for output and investment demand he was able to conclude that, there is a significant debt overhang and crowding out effect in Sub-Saharan Africa. In other words, the large stock of external debt and heavy debt service payments had a depressing effect on investment in SSA.

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He went further in simulating the implications of the debt reduction packages on economic growth. Upon simulating at different debt stock reduction levels he found that the hypothesized debt reductions assumed would increase investment and to a lesser extent the GDP on subsequent period. Simulations showed that a 50% debt stock reduction would have raised per capita gross domestic investment by over 40%, and increased GDP growth by over 3%, on average, during the 1987-1994 period.

Chowdhury (1994) used a structural simultaneous equation model built to capture the interrelationship between public and private external debt, capital accumulation and production function. The models were constructed basing on the inter-relationship between the variables that is, some of the variables have characteristic of both independent and dependent nature. Using the Granger causality test on the data set for indebted developing countries in Asia and Pacific, Chowdhury showed that, the Bulow-Rogoff (1990) proposition that the external debt of the developing countries is a symptom rather than a cause of economic slowdown is rejected. Also he further found that, the Dornbusch-Krugman proposition that external debt leads to economic slowdown is rejected. But a feedback-type relationship is not rejected for two countries.

The estimated results indicate that the overall effects of the public and private external debts on GNP are small and of an opposite sign, where as an increase in the GNP level raises substantially the public and private external debts. He argued that the positive estimates of the indirect effects of the public external debt on GNP obtained indicate that the capital flight

generated by tax rise expectations is smaller than the contribution of public  
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borrowing in financing investment in capital stock. Moreover, the direct and hence the full effects of the public external debt on GNP are positive and substantially large. An increase of 1% in the public external debt is likely to directly and indirectly raise the GNP level by 0.240% in the Asia – Pacific countries.

However, the adverse indirect effects of the external debt on GNP through lowering private investment and the overall level of capital stock are large in absolute value and substantially exceed the direct effect. Thus, the full effects of the private external debt on GNP are negative; a 1% increase in the private external debt is likely to reduce the GNP level by 0.033% during the time of study.

In his estimates also, the effect of GNP on capital stock is indirectly amplified by the positive effect of the public external debt on capital stock. The overall effect of GNP on capital accumulation is positive. The marginal product of capital is also positive and there is d