CHAPTER - I

INTRODUCTION
"Neither a borrower nor a lender be ----" begins Polonius' famous advice to his son, Laertes\(^{(1)}\). Economic theory appears to reject this admonition out of hand. Countries wanting to expand capital formation and economic growth beyond what can be financed by domestic savings should seek external financing. During the 1950s and early 1960s, export credits were the major source of financing, supplemented by foreign aid.

The past one and half decades will appear in future economic history as years of serious convulsions in the world economy, perhaps for the first time since 1930. Petroleum prices quadrupled in 1973-74 fell almost 20 percent between 1974 and 1978 and than again rose by 80 percent in real terms between 1979 and 1980. It almost remained constant till 1984 and again dropped after 1984. Not only were the magnitudes of these price shocks very large but their instability introduced stop go cycles and great uncertainty in world markets. To make matter worse for third world exporters, the industrial markets went into a recession in 1974-75 and again in 1979-80 followed each time by recovery. Even after 1980 these industrialized countries have been growing at a halting rate. On top of this induced instability, the world trade productivity slowed down in the advanced economies spread to the periphery as third world export demand sagged. As a result, the prices of many primary products exported by the third world have declined to their

\(^{(1)}\) William Shakespeare, Hamlet, Act I, Scene 3.
lowest level. In addition, much of the third world carry foreign
debt burden which were being shocked by rising interest rate in
capital markets representing rapid inflation and restrictive
monetary policy.

The concerned about the growth of external debt
of the developing countries takes numerous forms. One is that
individual countries will not be able to repay even if they are
willing. A second is that individual countries might not be
willing to repay even if able to. The distinction between the
capacity and willingness is important, for a lack of willingness
to repay when able to, implies a decision to cut or diminish
international relationship. The distinction between delay and
default is important. Delay suggests shortage of foreign
exchange while default suggests a political decision to rupture
external financial relationship. Debt crisis may take numerous
forms, at one extreme, some lenders may receive scheduled
payments of principal with modest delay but receive interest
payment on schedule. On the other hand, lenders may receive
nos. schedule payments either because the borrower disappears,
the government may be absorbed by some other government as a
result of non-peaceful changes in national borders. Between
these two extremes, there are numerous forms of crisis.

The distinction between capacity and willingness
is also important in terms of the form and amount of loss that
the lenders may incur if loans are not repaid on schedule.
Delays in payment need not cause any financial loss, for, that
may be more than compensated by increases in interest rates. Ultimately the private lenders may be bailed out from large loans to borrowers from national or international lenders or aid agencies. The large risks will be socialized by the governments in the lending countries.

Like other developing countries of the world, countries of South Asia, borrowed heavily from the international markets for their economic development. The SAC basically belong to low income countries. The SAC include seven countries namely - Bangladesh, Burma, India, Maldives, Nepal, Pakistan and Srilanka. Apart from geographical proximity and historical and cultural links, these countries are characterised by a number of common features and broad similarities of economic layout and trade and development patterns. There are, however, significant disparities among the countries of the region as in size, endowment of natural resources and pattern and level of socio-economic development.

**OBJECTIVES OF STUDY**

The present study has been undertaken with four broad objectives -

(1) The changes in the compositions and magnitude of rise in the flow of debt.

(ii) The growth of public debt both in nominal and real terms.

(iii) The debt paying capacity of SAC;
The contribution of different factors in the loan commitment.

We formulated the following hypothesis and have tried to test their validity:

(i) That the loan commitment is determined by the rate of interest;

(ii) that the maturity period influences the loan commitment;

(iii) that the grace period determines the loan commitment;

(iv) that the grant element has influenced the loan commitment.

1.1 METHODOLOGY OF STUDY

The data for the present study have been drawn mainly from the World Debt Tables and Report of the International Monetary Fund. There are, however, serious limitations to the World Bank Reports. The figures usually cited by the World Bank are incomplete till the year 1978. They did not include debts of less than one year or debts of the private sector not guaranteed by the governments.

The current value of external debt of the developing countries is also an area of uncertainty reflecting two factors - one is the problem of measurement. The data in many countries are incomplete because debt has been contracted by numerous government agencies and private agencies and private firms. The second involves conceptual problem; should
the external debt be measured gross or net, with the latter involving an adjustment for the external resources for the borrowers. Another conceptual problem is whether direct foreign investment should be included with external debt or not. The argument for inclusion is that the payments of dividends from subsidiaries in the developing countries are a charge in foreign exchange earnings similar to payments of interest, restrictions on such payments would inversely affect the influx of new direct investments or perhaps, even some portfolio investments.

Measurement is also complicated by inflation. At times the current account deficits in large developing countries are viewed as an indicator of their vulnerability to a debt crisis. But the surge in these current account deficits in part represents a response to increase in the interest rates on their external borrowings during an inflationary period.

One component of the interest payment is an inflationary premium intended to maintain the real value of the lenders wealth or at least to minimise the decline in its real value.

**Nominal and Real Value of Debt**

Analytical statements about the external debt of developing countries can be categorised according to the aspect of debt addressed. The set of statements deals with the growth of debt in nominal terms. A second test deals with the growth of debt in real or constant dollar terms, when adjustment from nominal debt involves the use of a deflator or deflators, which
reflect changes in prices of developing countries exports or imports or both together or some other price variables. A third set of statements involve the relation between the real or effective cost of incremental external debt and the returns earned by the investment financed by additional foreign borrowings. A fourth set involves the risk that some or all of the developing countries will not be able to repay their foreign creditor on schedule because of the shortage of foreign exchange, even though the debtors may be easily able to make repayment in their domestic currencies. In the present study, however, we have adopted the first two measures to assess magnitude of the rise in real value of external debt.

1.2 ABILITY TO SERVICE EXTERNAL DEBT

In analysing a country's position with respect to external debt it is important to distinguish the changes in the real values of external debt from the changes in the capacity to service external debt. The usual approach towards measuring capacity involves ratio analysis. Ratios are developed for the volume of imports to foreign exchange reserves or of debt service payments over some future period to exports of goods or of goods and services over the same period when one or several of these ratios become too high, the borrower is deemed unusually susceptible to a debt crisis.

The ability to service external debt depends on an income or quantity variable as well as price (e.g., terms of trade) variable. Thus, the ability to service external debt may
increase even if export price remain unchanged, if the volume of export's is growing rapidly. Hence a debt servicing ratio based on projected values for future years is some times considered more important than the ratio based on current values in determining the ability of a country to make its external debt payments on schedule. Changes in debt servicing ratio do not indicate whether a country had borrowed too much or too little but only that a crisis may occur at an unspecified future date if debt service payment continue to grow relative to exports.

At the conceptual level, a country might had borrowed too much from abroad even if its debt servicing ratio is falling. If the return on domestic investment were lower than the incremental interest rate on external debt. The debt service ratio could be declining because the maturity of debt is lengthening - proportionately more than the increase in income rate on their debt.

1.3 STATISTICAL TECHNIQUES

In our study, we have applied trend analysis correlation and multiple regression analysis to determine the influence of various factors in loan commitment. Description of the formula is given below:

**Multiple Regression** - We have form an equation for multiple linear regression to examine the impact of Interest Rate, Maturity Period, Grace Period and Grant Element on loan Commitment -
Whereas -

\[ \text{LC} = a + b_1 \text{IR} + b_2 \text{MP} + b_3 \text{GP} + b_3 \text{GE} \]

Compound Growth Rate - Compound growth rates are computed with the help of the following equation -

\[ Y = A B^t \]

Whereas -

\[ Y = \text{Index Number} \]
\[ A = \text{Constant (Intercept)} \]
\[ B = (1+r) \]
\[ r = \text{Annual growth rate expressed as percentage} \]
\[ t = \text{Time} \]

A schematic Diagramatic of the Plan of study is given overleaf.
LC = a + b_1 IR + b_2 MP + b_3 GP + b_3 GE

Whereas -

LC = Loan Commitment
IR = Interest Rate
MP = Maturity Period
GP = Grace Period
GE = Grant Element

Compound Growth Rate - Compound growth rates are computed with the help of the following equation -

\[ Y = AB^t \]

Whereas -

Y = Index Number
A = Constant (Intercept)
B = (1+r)
\( r \) = Annual growth rate expressed as percentage
\( t \) = Time

A schematic Diagramatic of the Plan of study is given overleaf.
**OBJECTIVE 1**

**CHANGING PATTERN OF EXTERNAL DEBT ASSESSMENT AND THE FLOW OF EXTERNAL DEBT**

**ITEM STUDIED**

**SOUTH ASIAN COUNTRIES AS A WHOLE**

1. **OFFICIAL CREDITORS**
   a. Multilateral
      i. IBRD
      ii. IDA
   b. Bilateral

2. **PRIVATE CREDITORS**
   a. Suppliers
   b. Financial Markets.

3. **GROWTH RATES**
   a. Commitments
   b. Disbursement
   c. Net flows
   d. Interest

**COUNTRYWISE STUDY OF THE ITEMS AS ABOVE**

**DATA SOURCES**

Published Secondary Data

**ANALYTICAL TOOLS USED**

1. **COMPOUND GROWTH RATE**
2. **PERCENTAGE ANALYSIS**

**CHAPTER - 3**

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**OBJECTIVE 2**

**TO ESTIMATE THE GROWTH OF PUBLIC DEBT BOTH IN NOMINAL AND REAL TERMS.**

**ITEM STUDIED**

**SOUTH ASIAN COUNTRIES AS A WHOLE**

1. Increase in Nominal Value of Debt Outstanding and Disbursed (DOD)
2. Increase in Real value of DOD as per (a) Deflated by General Price Index (b) Deflated by export prices

**COUNTRYWISE STUDY OF THE ITEMS AS ABOVE**

**DATA SOURCES**

Published Secondary Data

**ANALYTICAL TOOLS USED**

1. **INDEX NUMBER.**

**CHAPTER - 4**

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**OBJECTIVE 3**

**TO MEASURE THE DEBT PAYING CAPACITY.**

**ITEM STUDIED**

**SOUTH ASIAN COUNTRIES AS A WHOLE**

1. a) Ratio of Debt Outstanding to exports of goods and services
   b) Ratio of DOD to Gross National Product
   c) Ratio of DOD to Payment of Interest
   d) Ratio of Total Outstanding Liability to XGS

**DATA SOURCES**

Published Secondary Data

**ANALYTICAL TOOLS USED**

1. **RATIO ANALYSIS**

**CHAPTER - 5**

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**OBJECTIVE 4**

**TO ASSESS THE CONTRIBUTION OF DIFFERENT FACTORS IN THE LOAN COMMITMENT.**

**ITEM STUDIED**

**SOUTH ASIAN COUNTRIES AS A WHOLE**

1. Loan commitment is governed by
   a. Maturity period
   b. Interest Rate
   c. Grace Period
   d. Grant Element

**COUNTRYWISE STUDY OF THE ITEMS AS ABOVE**

**DATA SOURCES**

Published Secondary Data

**ANALYTICAL TOOLS USED**

1. **MATRIX CORRELATION**
2. **MULTIPLE REGRESSION**
3. **ANALYSIS OF VARIANCE**

**CHAPTER - 6**

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**OBJECTIVES**

**CONCLUSION AND SUGGESTIONS**

**CHAPTER - 7**

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1.4 LONG TERM EXTERNAL DEBT

Long term external debt is defined as debt that has an original or extended maturity of over one year and that is owed to non-residents and repayable in foreign currency, goods or services. A distinction is made between -

(a) Public debt, which is an external obligation of a public debtor, including the national government, a political subdivision (or an agency of other), and autonomous public bodies.

(b) Publicly guaranteed debt, which is an external obligation of a private debtor that is guaranteed for repayment by a public entity.

(c) Private nonguaranteed debt, which is an external obligation of a private debtor that is not guaranteed by a public entity.

Short-term external debt is defined as debt that has an original maturity of one year or less. Available data permit no distinctions between public and private non-guaranteed short-term debt.

1.5 REVIEW OF THE LITERATURE

Literature on the problem related to external obligation of South Asian Countries as such is hardly available but many studies have been completed on the debt problem of less developing countries. We shall make review of the literature in the subsequent paragraphs mostly dealing with the problems of under developed countries.
Hughes (2) estimated the external medium term and long term debt of developing countries. She divided the period of study into three viz. 1956-65, 1967-72 and 1972-76. She estimated the rise in external obligations from official and non-official sources separately during all the three periods and from both the sources there had been a fall in the growth rate, of external debt. Though the fall had been more pronounced in the last phase, followed by the second one.

Cizauskas (3) in his studies concludes that numerous accounts are available of the external debt of the developing countries. Many of these studies according to him provide quantitative details of the recent growth, character and size of the debt or discuss its implications to creditors.

Little has been said, however, of the diversity in the treatment over time of individual debtor countries by creditors when relief of contractual obligations was required and what had motivated creditors when doing so. In his study, he has made a qualitative and selective review of international debt relief negotiations. India and Pakistan, the two major partners of South Asian Countries got debt relief within the

context of aid consortia chaired by the World Bank. In both the cases debt relief was viewed in a broader framework which included concerns for the countries longer term development needs. However, the treatment given to the two countries differed substantially.

Feder\(^4\) links a simple aggregate model or growth cum external debt with an empirical formula for debt servicing capacity. Through simulations of growth and debt patterns using data related to two groups of less developed countries, the underlying conditions and the pattern of debt service problems which emerge are studied. Simulations of policies designed to alleviate debt service problems allows an assessment of the efficiency and suitability of different policies. The time dimensions of debt problems and its relevance to policy are considered as well as. The study raises doubts regarding the applicability of accepted beliefs and rules of thumbs related to external debt management.

Aliber\(^5\) postulates that debt crisis might result from solvency problems or liquidity problems. A solvency problem

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would mean that the real interest rate on the marginal external loan exceeded the increase in national income made possible by this loan. A liquidity problem would mean that the borrower would be unable to obtain the foreign exchange to make the debt service payments on schedule. The thesis of the paper is that the external debt of most developing countries will increase for the foreseeable future and that crisis occur when the refunding mechanism breaks down either because the lenders are reluctant to external new credits as they mature or because the borrowers are reluctant to refinance due to very high short term effective interest cost. If borrowers expect that domestic currencies may be devalued they will delay refinancing to avoid the exchange loss.

Examination of debt crisis over the last several decades reveals that most debt crisis occur when currencies are overvalued. The evidence was strong that most of the countries involved had overvalued currencies. The plausible inference is that most if not all of these currencies should have been devalued. Hence the strong association between debt crisis and devaluation is consistent with the view that the external debt problem is primarily a liquidity issue.

Long and Veneroso of Boston University\(^{(6)}\) calculated the nominal and real value of external obligations of

non-oil less developed countries by deflating the price index and also by deflating the export and import prices for the period 1972-77. They also measured the ratio of nominal debt to nominal gross national product, and nominal debt to nominal exports for the same period. The rise in the real value of external debt by all the three criteria was for less than that of nominal value. However, marginal rise in the two ratios were evinced during the terminating year.

Hope (7) has examined the borrowing patterns of developing countries as they have evolved over the past decade by drawing in data contained in the Debtor Reporting System of the World Bank Changes in the debt situation of these countries in aggregate for important sub-groups and individually - are assessed by a consideration of debt and associated service payments have changed relative to major macro economic variables that are often used to assess a borrowing country's credit worthiness.

In another study Feder and Others (8) have devised an empirically based composite indicator of the likelihood

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of debt servicing difficulties. The method is, however, implied as a substitute for a thorough country analysis which takes into account a host of non quantifiable factors such as internal and external political situations, governmental priorities and competence of the economic leadership. Rather the two level of analysis should be complementary. It is hoped that future research will suggest ways for incorporating variables which are presently excluded because of measurement difficulties.

De Vries (9) takes a comprehensive view of the policies required to alleviate the present international debt predicament. He concludes that not only are urgent measures needed to improve the cash position of the debtor countries but also a large proportion of new finance must be made available in long and stable terms. Such finance should be provided for investment programmes and projects agreed upon with official and private sources in a new growth oriented effort. According to him, the present situation is particularly difficult because debtor countries are in a severe depression and are not receiving any new finance for productive purposes looking forward the paper stresses that interest rates and export performance hold the key to the viability of the debtor countries. Essential export growth must be based on the debtor countries own efforts and supported by open trade policies in the creditor

countries. Interest rates although low in nominal terms are still high in real terms. Consideration should be given to compensation on a selective basis for high and fluctuating market interest rates.

Mukherjee (10) has studied the factors determining loan commitments of less developed countries. The extents of debts incurred by the LDCs has been governed by four basic factors - Maturity Period, Grace Period, Rate of Interest and Grant Element. He concludes that the different regions forming LDCs have experienced various treatment to their relative creditors. All the regions have experienced a falling percentage of grant element in their loan commitments and have been subjected to increasingly higher rate of interest. The maturity period have fallen for all the regions accepting South Asia. The number of grace years allowed by the creditors have however, not been uniformed.

Sanderson and Williamson (11) review two types of existing studies. The first consists of cross country comparative

(10) Mukherjee, A. - Loan Commitment of Less Developed Countries, A study in retrospect - The Indian Economic Journal, January to March 85, pp. 60-77.

studies of the shock policy adjustment relationship, the second of eight exercises in quantitative modelling of individual countries. It attempts to infer elements of the relationship from existing exercises using these quantitative analytical tools. As a result, the treatment of the issues and results is not uniform. Far more could have been extracted from the country studies had it been possible to subject the various models to comparable scenarios. The paper does, however, provide an indication of some important interaction between shocks, policy and performance as well as an overview of the various modelling frameworks used in country analysis.

In 1985 a consensus emerged in the international Committee(12) that the debt servicing problems of many highly indebted middle income developing countries were protracted rather than temporary and that their long term solution depended critically on restoration of sustained growth in these countries. Reflecting their consensus the Development Committee at its twenty seventh meeting in Seoul, Republic of Korea requested the World Bank to prepare a report on how sustained growth can best be achieved in these countries.

The World Bank Report concludes that from the early emergence of the debt problems it has been generally

understood that improved domestic policies in indebted developing countries and a strong and sustained recovery in the industrial countries are essential for restoration of credit worthiness and growth. In this context, the committee highlights in concerted action in international trade. The importance of increasing developing country exports and towards this end the need for collaborative action by industrial and developing countries to liberalize international trade.

The report concludes that a healthy recovery of the world economy and vigorous pursuit of appropriate adjustment policies by developing countries alone are not enough to restore growth in the latter. A significant expansion of private and official lending to countries that pursue effective policy is also needed.

Clairmonte and Cavanagh(13) writing on the problem of third World Debt conclude that it is impossible to even repay the outstanding principal of the Third World. They also observe that simply differing interest payments and principal to the transnational banking circuit and seeking like an obsequious mendicant, rescheduling agreements will perhaps investigate the bleeding and the pain, it can by no means stop the haemorrhage. Nor is it that the debt should be repaid.

according to them debt repudiation stands out as the only ethically feasible and rational solution for the third world.

Mukherjee (14) studying borrowing and debt servicing problem in South Asia, found that though the need for external financing increased in South Asia the prospects of foreign aid did not appear encouraging specially after 1979. India and Pakistan's use of IMF credit increased since 1981 when their exports and remittances declined. She also conclude that debt servicing problems of South Asian Countries were not serious in comparison to many developing countries who were caught in a debt trap by the beginning of the 80s.

Thomas (15) observes that three major issues have emerged from adjustment lending. One is translating adjustment policy into improved economic performance. The second is reconciling policy reforms with changing external conditions. The third is coordinating the adjustment process itself - coordinating the efforts of all the interested parties inside and outside the country. According to Thomas in relation to each of these issues expanding the menu of policies options could make adjustment packages more credible and effective. Its results depend upon cooperation among governments, international organization and the commercial institution. It requires the patience to listen to and understand differing perspectives. It requires the flexibility to consider and expanded menu of options for development. It also requires insight and luck.


Stanley Fischer\(^{(16)}\) observes that debtors and creditors including the international institutions should work towards long-term adjustment plan that censured debtor country of adequate resource flow over several years and that lead to needed policy changes during the period of adjustment. There should be no understanding the difficulty of formulating and implementing consistent adequately funded medium term adjustment programme. Equally there should be no understanding the importance of restoring investment and growth in the debtor countries \(------\) not only for the economic and political development of these countries but also to prevent further worsenening of the international debt situation.

To restore growth in highly indebted countries debt reduction alone is not as efficient as simultaneously providing liquidity, debt reduction, and possibly conditionality. Indeed many countries might not require debt reduction if liquidity and conditionality were available\(^{(17)}\)

Bhandari\(^{(18)}\) and others had developed a macro-economic model for a small open developing economy that

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borrows abroad in order to study the dynamic intersection between the debt and growth, as well as the impacts of various policies and exogenous shocks on the rate of capital accumulation, the current account and debt. The framework that has been employed is that of inter-temporal optimizing representative agent model which has increasingly been used to advantage to analyse a variety of issues in international macroeconomics.

Eugene L. Versluysen (19) writing on the alternative debt strategies found that proposals to increase official and commercial lending to the Highly Indebted Countries (HICs) have received widespread support. Some are already being implemented. Japan's recycling plan is in force; the World Bank's recent capital increase will enable it to expand its own project and program lending. Through confinancing programs, direct guarantees and other techniques, the World Bank and its affiliated institutions, IFC and MIGA, are expanding their catalytic role to stimulate commercial lending to selected HICs. Risk hedging is also being implemented on a selective basis. A small number of developing countries have already introduced interest and currency swaps in their debt management programs.

Barry Eichengreen and Richard Porte (20) concludes that the international debt crisis of the 1930s and the 1980s differ in fundamental ways. In the 1920s lending was mediated by the bond market, in the 1970s by the commercial banks. Since the lending mechanism differed, so did the mechanism for negotiating readjustments of defaulted debts. In the 1930s outright default was common, albeit sporadic. In the 1980s, in contrast, serial reschedulings and other expedients so far have prevented a significant spread of formal default.

In the 39th meeting of the joint Ministerial Development Committee (21) of the Boards of Governors of the World Bank and the International Monetary Fund on the transfer of Real Resources to Developing Countries (Development Committee) concludes that debtor countries need to pursue strong adjustment programs, supported by determined structural reforms that are aimed at increasing domestic resources mobilization, attracting non-debt-creating flows, and reducing impediments to growth. Creditors and donors need to ensure the provision of adequate external financing in support of such programs on a case-by-case basis.


The debt of low-income developing countries represents mainly liabilities to official creditors. In spite of generous cash flow relief provided by official bilateral creditors, Toronto-terms reschedulings with concessional options, external viability remains highly uncertain for the most severely indebted low-income countries.

The discussion (22) of the current debt situation held in the seminar at Jeddah, May 1990, highlighted that, under the prevailing economic conditions, many developing countries are facing financial and economic problems. These countries are confronted with problems of (a) large debt repayment obligations on existing debt, (b) frequent exchange rate fluctuations especially against hard currencies and thus additional requirement of local currency to pay the same amounts, (c) reduced availability of funds from private sector; and (d) worsened debt GNP and exports ratios.

It was suggested that developing countries may outline their borrowing policies based on the criteria of payment capacity, comparative advantages and diversification of the economy, taking into consideration of the availability of natural resources and their efficient allocation to various sub-sectors of the economy.

Writing a paper for the evolution of adjustment programs, the design and implementation of conditionality William A. McCleary (23) gives important indications of what works and what does not, of what needs changing and what should not even be attempted in the contest of adjustment lending. More broadly, it shows a greater need for selectivity in adjustment lending to ensure that loans will be effective and they do not serve merely to postpone adjustment by relieving resource constraints.

Writing about Pakistan's structural adjustment and economic growth William A. McCleary (24) writes although reforms undertaken during 80s' improved performance and the capacity to respond to economic change there are some worrisome signs. Controls, over-investment remain instrusive while in the crucial area of the budget and the trade regime, major changes yet to some. Fundamental reform of public sector resource mobilization remains to be undertaken and budget deficits have been running at unsustainable levels. Many consumer goods remain subject to quantitative restrictions and the average level of tariffs is still very high, so anti-export bias remains significant.

In the book entitled The External Debt, fiscal policy and sustainable growth in Turkey, Sweder Wijnbergen and


(24) Ibid - Page 432.
others (25) writes that Turkey has demonstrated that the possibility of a growth oriented debt strategy by maintaining growth rates substantially higher than those of post 1982 Latin America countries without increasing its debt output ratio much more than they did. According to them Turkey accomplished this with intelligent economic policy rather than luck which means that if other countries adopt Turkey's policy, they can expect similar economic achievements.

Another World Bank Technical Paper (26) on debt conversion programs and conversion activities deal with the amalgamation of the existing literature on debt conversion in a concise and unique manner. The theme of the paper is to find out the link between debt conversion, foreign investment and privatization.
