An inquiry into the macroeconomic impact of foreign aid on developing countries: Impact of external indebtedness on economic growth and poverty in Sri Lanka

By

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Abstract

Development literature provides a macroeconomic rationale for foreign aid when there is a deficiency in domestic savings, foreign exchange or government revenue. Focus is then on closing resource gaps and no distinction is usually made between aid and grants and loans. But problems arise when aid loans are used to fill the resource gap, as the recipient country has to bear many costs in the future. External debt may have adverse implications for the savings, foreign exchange, growth and poverty and macroeconomic performance. There may be two types of problems, debt capacity problem and debt related development problems. The first problem arises when the debtor country is unable to honor debt service obligations as they come due. The other problem arises when a country's foreign debt is so large as to adversely affect economic development efforts.

It is apparent that Sri Lanka also is no exception to other developing countries in need of foreign aid to achieve her growth prospective. Although Sri Lanka has obtained a gradually increasing quantum of large external debt (since 1977) to bridge the internal and external resource gaps, in retrospect it is seen that during a period of three decades its average growth rate has varied only very slightly around four percent. Also though poverty alleviation has been given priority within the development goals yet increasing poverty has become an aggravating problem.

The main purpose of this study is to analyze the question of how external debt and indebtedness affect a country's economic growth and poverty. Taking into consideration the external debt difficulties facing the countries at present, this study is presented as a case study for Sri Lanka. Accordingly, it has examined three main hypotheses,

- External debt impacts significantly towards improving economic growth and reducing poverty
- Indebtedness affects economic growth and poverty adversely
- Government debt and debt servicing caused increase of poverty

The empirical investigation was done using the secondary data obtained from library survey and regression coefficients were estimated by using the method of OLS.
According to the hypotheses tested it is proved that there is no significant positive relationship between external debt and economic growth. But some possibilities having positive impacts on growth is seen. Secondly the impact of external indebtedness on poverty and economic growth is adverse as postulated by the second hypothesis was not proved by the estimates when indebtedness was taken as a whole. But it is likely to affect poverty and economic growth through other macroeconomic variables. Thirdly, a significant negative relationship is found between economic growth and government debt and also between government debt and poverty, proving the third hypothesis, which states that the government debt and debt servicing affect poverty adversely. Accordingly it is concluded that the overall debt situation has not reached an unsustainable level, the government debt situation is obviously unsustainable.

Formulation of a national policy to obtain manage and utilize external debt, taking necessary actions to address poor revenue performance by removing the inefficiencies of tax structure and restructuring the system where it is necessary, adopting a suitable exchange rate policy so that the unfavorable effects of currency composition and fluctuations of export import prices are minimized, cautious use of foreign capital for the balance of payment problems and specially attempting to raise domestic savings are some of the policy implications which emerged from the above findings.
# Table of Contents

Abstract III  
Acknowledgement V  
Table of Contents VI  
List of tables X  
List of figures XII  

**Chapter one: Introduction**  
1.1 Background of the study 1  
1.2 Research problem 3  
1.3 Objectives of the study 5  
1.4 Debt, growth, poverty in the literature 6  
1.5 Methodology, Data, Model and Limitations of the Study 9  
1.5.1 Formulation of hypothesis 9  
1.5.2 Selection of variables 10  
1.5.3 Data sources 13  
1.5.4 Selection of time period 13  
1.5.5 Specification of the model 14  
1.5.6 Limitations 15  
1.6 Organization of the Thesis 16  

**Chapter two: Macroeconomic Impact of Foreign Aid**  
2.1 Macroeconomic rationale for foreign aid 18  
2.2 Theory of external debt and economic performance 27
### Chapter three: The external debt problem in developing countries

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1</td>
<td>36</td>
</tr>
<tr>
<td>3.2</td>
<td>27</td>
</tr>
</tbody>
</table>

#### 3.2.1 External debt: 1973-82
- Status of the stock, composition, structure of external debt and debt service: 44
- Indebtedness and external debt and debt service: 49

#### 3.2.2 External debt: 1983-1992
- Status of the stock, composition, structure of external debt and debt service: 51
- Aggregate resource flows: 56
- Indebtedness and external debt and debt service: 60
- Average terms and concessionality: 62

#### 3.2.3 Recent trends in external debt
- Status of the stock, composition, structure of external debt and debt service: 63
- Aggregate resource flows: 72
- Indebtedness and external debt and debt service: 77
- International responses to debt difficulties: 79
- Average terms and concessionality: 81

### Chapter four: External Debt in Sri Lanka

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.1</td>
<td>85</td>
</tr>
<tr>
<td>4.1.1</td>
<td>85</td>
</tr>
<tr>
<td>4.1.2</td>
<td>86</td>
</tr>
<tr>
<td>4.1.3</td>
<td>92</td>
</tr>
<tr>
<td>4.2</td>
<td>95</td>
</tr>
<tr>
<td>4.2.1</td>
<td>95</td>
</tr>
</tbody>
</table>
4.2.2 External resource gap

4.3 Trends in poverty

4.4 External debt in Sri Lanka

4.4.1 External debt: 1970-1983
   Status of the stock, composition, structure of external debt and debt service
   Aggregate resource flows
   Indebtedness and external debt and debt indicators
   Average terms and concessionality

4.4.2 External debt: 1984-1993
   Status of the stock, composition, structure of external debt and debt service
   Aggregate resource flows
   Indebtedness and external debt indicators
   Average terms and concessionality

4.4.3 External debt: 1994-2002
   Status of the stock, composition, structure of external debt and debt service
   Aggregate resource flows
   Indebtedness and external debt indicators
   Average terms and concessionality
   Currency composition

4.5 Government debt

4.6 Problem of aid underutilization