Statement of Candidate

I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person nor material which to substantial extent has been submitted or accepted for the award of any other degree or diploma of a university or other institute of higher learning.

Signature Date

Statement of the supervisor

I hereby certify that I have supervised this dissertation

Name of the supervisor: Mrs. G.W. Indrani

Signature Date

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.

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Chapter One

Introduction

1.1 Background of the study

The Marshall plan initiated the grant of foreign assistance or development assistance to countries in the third world for their economic growth and promotion of development following the Second World War. Although at first the objective was reconstruction and rehabilitation of the war-ravaged countries, its explicit aims later turned to alleviation of capital deficiency and the removal of growth constraints in developing countries generally. Many developing countries utilized these foreign capital flows that poured in the form of foreign loans for achieving their growth and development objectives in which attempt some countries successfully attained their goals. On the basis of their success, development economists expounded various theories and showed in the 1950s and 1960s and until the latter part of the 1970s how beneficially important external financing was for development and economic growth. In the light of these theories it was explained how these foreign finances were a strong factor to bridge the gap in investment mostly faced by developing countries by inadequacy of savings and the foreign exchange gap caused by insufficient foreign exchange earnings, headed by export earnings that are not adequate even to meet the import expenditure on essential and intermediate goods and how economic growth and resultant development can be effected by means of earning sufficient resources from investment financing. If, however foreign exchange is to have a favorable impact on country's obtaining such loans they should employ them for increased production and thereby achieve debt repayment capacity, and also utilize them for increasing exports and foreign exchange, which will do away with any risk in repaying the loans. At the same time, with a country achieving good work results it would emerge from debtor to creditor status.

With the dawn of the 1980s, however, their optimistic view of foreign aid began to change. Many developing countries started facing difficulties in regard repaying the loans received an accumulation of debt servicing in those countries proved to be an oppressive_factor that weighed them down heavily. Consequently some countries (e.g. Mexico) declared that they wouldn't repay the loans and later this situation proved into a debt crisis. This resulted in many creditor countries and organizations being disinclined to grant loans to third world countries and they imposed various conditions for the granting of loans, amongst which various adjustment measures were implemented. With payment charges, however, reaching unmanageable levels and consequent strong constraint on economic activities and in the absence of an alternative, many developing countries had to accept these adjustments and other conditions. Simultaneously with this situation ideologies and views relating to external debt and economic growth held so far began to be controversial.

By now, in the analysis of the subject of external finance in developing countries, it was not considered of much importance but it was recognized that there were pre-requisites that were called for if the impact of external debt was to be favorable. The empirical studies, however, conducted on the subject brought out contradictory conditions especially with the revelation that external debt affected adversely on economic growth in the light of many studies carried out, the relationship between external financing and economic growth became suspect. Going along further in this trend many studies pointed out that external debt far from being a factor leading to economic growth was in fact a growth constraint. At the same time in Sub Saharan African (SSA) countries with increasing poverty, hand-in-hand with indebtedness, their problem received attention from another angle and it was pointed out that external debt has an unfavorable effect on growth and with its trickle down effects increased poverty. On the other hand in the face increasing the debt servicing governments, finding themselves in the midst of fiscal pressures tend to retrench budgetary allocations on social expenditure and poverty alleviation and it was thus pointed out that external debt directly caused increasing poverty.

1.2 Research Problem

As in the case of many developing countries there was no alternative for Sri Lanka too to realize its growth and development objectives other than resorting to foreign aids. The different governments coming into the power began following diverse economic policies in order to find solution for the existing macroeconomic problems and for effective development. For implementing such policies, the main problem Sri Lanka faces as do the other developing countries is lack of capital. Supply of capital or the presence of adequate savings for investment within a country is an essential factor for its economic growth. Sri Lanka's percentage of savings in relation to the GDP is between 16 and 20 percent, whereas it should be at least thirty percent if to attain a favorable economic growth level. Thus the country has to resort a foreign aid as the main solution for bridging the internal resource gap since the pre-requisites of considerably increasing non--debt-creating inflows were not sufficient in the country. Similarly for the purpose of bridging the foreign exchange gap or in very simple terms to obtain resources for import financing, Sri Lanka has to depend heavily on foreign debt. A country obtains foreign debt to get over its difficulties in order to raise its economic growth level and attain its development objectives, thereby, in which abolition of poverty is one of the main features.

Development is not the mere achievement of economic growth. The benefits of economic growth should flow down equitably to all communities in a country, which would enable every citizen to meet their basic needs and lead a comfortable life. If this does not happen, the marginalized communities deprived of benefits will be a constraint against economic growth. In this light, one of the primary objectives of development is abolition of poverty. During the period of more than three decades past Sri Lanka's economic growth level has seldom changed from 4 percent and in spite of the variety of measures adopted poverty. Especially non-income poverty is rising. This has resulted in, on the one hand foreign debt going up and the objectives to be achieved there from being lost on the other.