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**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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# Table of Contents

Abstract	III
Acknowledgement	V
Table of Contents	VI
List of tables	X
List of figures	XII
<b>Chapter one: Introduction</b>	<b>1</b>
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
<b>Chapter two: Macroeconomic Impact of Foreign Aid</b>	<b>17</b>
2.1 Macroeconomic rationale for foreign aid	18
2.2 Theory of external debt and economic performance	27



<b>Chapter three: The external debt problem in developing countries</b>	<b>35</b>
3.1 The origins and evolution of debt creating inflows	36
3.2 External debt in the third world	27
3.2.1 External debt: 1973-82	41
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	51
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	63
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
<b>Chapter four: External Debt in Sri Lanka</b>	<b>83</b>
4.1 Macroeconomic performance since 1970s	85
4.1.1 Economic growth	85
4.1.2 Savings	86
4.1.3 Investment	92
4.2 Resource gaps	95
4.2.1 Internal resource gap	95

4.2.2	External resource gap	97
4.3	Trends in poverty	101
4.4	External debt in Sri Lanka	105
4.4.1	External debt: 1970-1983	105
	Status of the stock, composition, structure of external debt and debt service	105
	Aggregate resource flows	108
	Indebtedness and external debt and debt indicators	110
	Average terms and concessionality	111
4.4.2	External debt: 1984-1993	112
	Status of the stock, composition, structure of external debt and debt service	112
	Aggregate resource flows	114
	Indebtedness and external debt indicators	116
	Average terms and concessionality	116
4.4.3	External debt: 1994-2002	118
	Status of the stock, composition, structure of external debt and debt service	118
	Aggregate resource flows	124
	Indebtedness and external debt indicators	126
	Average terms and concessionality	130
	Currency composition	132
4.5	Government debt	132
4.6	Problem of aid underutilization	143



<b>Chapter five: Impact of External Debt and Indebtedness on Economic Growth and Poverty in Sri Lanka: an econometric analysis</b>	<b>146</b>
Results and discussion	146
<b>Chapter six: Summery, Conclusion and Policy Implications</b>	<b>156</b>
6.1 Summing up	158
6.2 Conclusion and policy implications	162
Bibliography	163
Annexure I	182
Annexure II	184
Annexure III	187
Annexure IV	190



## List of Tables

	Page No
Table 3.1 Non-oil developing countries; current account financing	43
Table 3.2 Non-oil developing countries external debt; US\$ billions	44
Table 3.3 Developing countries: external debt relative to exports and GDP	45
Table 3.4 Developing countries: distribution of long-term external debt by type of the creditor	46
Table 3.5 Developing countries debt service payments	46
Table 3.6 Developing countries: distribution of long term debt	47
Table 3.7 Non-oil developing countries: structure of external debt	48
Table 3.8 Indebtedness indicators of non-oil developing countries	49
Table 3.9 Developing countries: total external debt	51
Table 3.10 Developing countries: external debt by type of the creditor	53
Table 3.11 Developing countries: external debt by type of the creditor	54
Table 3.12 Developing countries: External debt by region	54
Table 3.13 Developing countries: external debt service by region	55
Table 3.14 developing countries: structure of external debt by maturity	55
Table 3.15 Total Net resources Flows to Developing Countries	57
Table 3.16 Developing countries: Debt indicators	60
Table 3.17 Average terms of new commitments	62
Table 3.18 Developing countries: total debt	63
Table 3.19 Developing countries: composition of external debt	65
Table 3.20 Developing countries: aggregate net resource flows (long term)	72
Table 3.21 Developing countries: total disbursements by creditor	73
Table 3.22 developing countries: debt service	75
Table 3.23 Developing countries: debt indicators	77
Table 3.24 Net Transfers on debt by type of the creditor	78
Table 3.25 Developing countries: debt-restructuring	80



Table 3.26	Developing countries: external debt; average terms of new Commitments	81
Table 4.1	Sri Lanka: Economic Growth	85
Table 4.2	Sri Lanka: Gross Domestic Savings	87
Table 4.3	Sri Lanka: Government Fiscal Operations: Current Account Balance	90
Table 4.4	Sri Lanka: National Savings Ratio	91
Table 4.5	Sri Lanka: Gross Investment Ratio	93
Table 4.6	Sri Lanka: Investment Savings Gap	95
Table 4.7	Sri Lanka: current Account Deficit on BOP	98
Table 4.8	Filling Internal Resources Gap	99
Table 4.10	Filling the External Resources Gap	100
Table 4.11	Incidence of poverty: based on national poverty line	104
Table 4.12	Total External Debt	105
Table 4.13	Structure of external debt	107
Table 4.14	External debt service	108
Table 4.15	Aggregate net resource flows on long-term debt	108
Table 4.16	Indebtedness Indicators	110
Table 4.17	Average terms of new commitments	111
Table 4.18	Total debt	112
Table 4.19	Structure of external debt	113
Table 4.20	Net Flows and Net Transfers	114
Table 4.21	Aggregate net resources flows on long-term debt	115
Table 4.22	External debt indicators	116
Table 4.23	Average terms of new commitments	116
Table 4.24	Total external debt	118
Table 4.25	Structure of outstanding external debt	120
Table 4.26	External debt service payments	122
Table 4.27	Net flows and Net transfers by creditor category	124
Table 4.28	Aggregate net resource flows	125
Table 4.29	Indebtedness indicators	127

Table 4.30	Debt service ratio	127
Table 4.31	Comparison of debt indicators - 2002	129
Table 4.32	Average terms of new commitments	131
Table 4.33	Currency composition of external debt	132
Table 4.34	Outstanding Government Debt (at the end year)	135
Table 4.35	Government debt	136
Table 4.36	Government debt service	138
Table 4.37	Currency composition of Government debt outstanding 1995 -2003	139
Table 4.38	Effect of exchange rate variations on foreign loans	140
Table 4.39	Government debt indicators 1999 - 2003	141
Table 4.40	Utilization of foreign aid by type	143
Table 4.41	Foreign aid disbursements by type	144
Table 5.1	Regression Results 1980-2002	146
Table 5.2	Regression Results 1980-1991	150
Table 5.3	Regression Results 1992-2002	151
Table 5.4	Regression Results 1992-2002	153
Table 5.5	Regression Results 1980-1992	154

## List of Figures

Page No.

Figure 2.1	Schematic representation of the procedure for estimating foreign resources requirement for growth and development	23
Figure 2.2	Debt Cycle	28



# **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.