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# Development Through Debt: Rationalizing the Costs of External Borrowing

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**Mounting external indebtedness has become a major problem for many developing countries. This may be not least a result of the fact that economists and policy-makers have tended to emphasize the benefits to the recipient countries of external borrowing to the neglect of its costs.**

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Foreign capital inflows are generally considered to bring economic benefits to developing countries. But they can also bring costs, even in the case of grants. Thus the need arises, especially in the case of loans, for weighing the benefits against the costs, and for ensuring that net benefits accrue to the recipient country.

This article is a critical examination of the economic rationalizations for external borrowing usually found in the literature. That there are benefits to the borrowing country is not in question. But it seems that the benefits have been emphasized to the neglect of costs. A balance needs to be struck. And that is what this theoretical critique attempts to do.

## Fixed Capital as the "Engine of Growth"

One primary objective of capital inflows, including external borrowing, is said to be to enable a developing country to increase its rate of investment. This forms the central basis justifying most forms of foreign assistance from the industrialized to the non-industrialized countries.

But an external loan usually carries the cost of amortization and interest, payable in foreign exchange. Since foreign exchange "is one of the scarcest, if not the most scarce, input for the developing debtor countries"<sup>1</sup> the opportunity cost of these payments may be quite high. Hence, the general acceptance of external borrowing by the developing countries as a means of effecting increases in their rates of investment may reflect their high valuations of the present and future benefits of such increases in investment.

This high valuation may stem from the general assumption that higher growth rates for developing economies hinge primarily on higher rates of fixed capital accumulation. The basis for this crucial role of fixed capital as the "engine of growth" has been refuted by Cameron: "Economists from Marx and Engels to Harrod and Domar, as well as earlier and more recent ones, have stressed the preeminent importance of the role of capital in economic growth . . . Although a few countries have achieved relatively high rates of growth by assigning such a role to capital, the results as a whole have been far from satisfactory; nor is there any clear correlation between investment ratios and rates of growth."<sup>2</sup>

The assumption of this role is questionable, even when considering the earlier development of the present industrialized economies. Rostow's "take-off" hypothesis, which relied so much on the history of the economic development of North America, Western Europe, Russia and Japan, and which assigned a central role in development to capital, had seemed to provide, in the late 1950s and early 1960s, a much needed fresh empirical support for the theoretical preeminence of this role. He had stressed that the achievement of "take-off" into self-sustaining growth required the "rate of effective net investment and savings to rise from, say, 5% of national income to 10% or more".<sup>3</sup>

But more "recent historical research", cited by Cameron<sup>4</sup>, on some of the same countries which provided Ros-

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<sup>1</sup> D. Avramovic et al., *Economic Growth and External Debt*, Baltimore, Md., 1964, p. 42.

<sup>2</sup> Rondo Cameron, *Economic Development: Some Lessons of History for Developing Nations*, in: *American Economic Review*, May 1967, p. 313.

<sup>3</sup> W. W. Rostow, *The Stages of Economic Growth*, London 1960, p. 7 f.

<sup>4</sup> Rondo Cameron, op. cit., p. 313 f.

tow's basic data, has refuted Rostow's criterion for "take-off" and shows "that almost every developed country of today entered a phase of sustained growth with investment ratios substantially below the magic figure of 10 percent". Cameron suggests that "the increase in the investment ratio is a consequence rather than a cause of economic growth", and that improvements in "technical and organizational skills", even unaccompanied by increases in net investment, may be more important.<sup>5</sup>

Concentration on this role of capital is sometimes justified by observing that capital is "the scarce factor" limiting growth. Hence, the assumption of the central role of capital in growth further implies that either the other co-operating factors are unimportant, or they are available in the requisite, or even over-abundant, amounts. While the former implication can be easily ruled out with regard to the vast majority of economists, the latter cannot. Indeed, labour surplus has become one of the definitional characteristics of a developing economy.<sup>6</sup> It is also amazing that, with the assumption of a labour surplus and of Malthusian population explosion, which should actually imply the scarcity of land as a factor of production, land is also generally assumed to be available in abundant amounts for agricultural expansion.<sup>7</sup>

While these may be necessary simplifying assumptions in theoretical models, the existence of adequate supplies of any factor of production cannot be assumed in planning economic development. In particular, it should be noted that labour is not a homogeneous factor. Surpluses of particular types of labour may even persist alongside acute shortages of other types.

In the light of all the above, it seems that the traditional emphasis on the role of capital in economic development deserves a serious reconsideration. We are particularly concerned about the tendency of this emphasis to increase the external debt of the non-industrialized countries.

### Supplementation of Domestic Savings

The apparent lack of domestic savings in the non-industrialized countries makes an assumption of a crucial role for net capital inflows virtually self-justifying. Thus Fei and Paauw assign them "a strategic role in promoting progress toward self-sustained growth" and assume that the total of such net inflows supplement domestic saving in financing investment.<sup>8</sup> Similarly, Chenery and

Strout point to "the net flow of some \$ 9 billion per year from advanced to less developed countries" as a "crude measure" of their dependence on external resources for increasing their per capita incomes.<sup>9</sup>

Net capital inflows are also supposed to fill the foreign-exchange gap and thus release the recipient economy from the foreign-exchange constraint during the development period. Since the foreign-exchange gap bears an *ex post* identity to the domestic saving gap, capital inflows also function to fill this gap, thus helping to relax the saving constraint. It is really from this role of permitting higher rates of investment than can be financed from domestic saving alone, that the other benefits of external borrowing and other types of foreign capital are supposed to flow. These include higher growth rates of employment and income, and higher rates of technological progress.<sup>10</sup> Of course, with these go higher levels of consumption and general social welfare, higher growth rates of exports and imports, and perhaps the generation of self-sustaining growth.

### Assumption of Positive Net Benefits

But the implicit assumption here is that, if there are any costs to the recipient of capital inflows, including "hard" loans, such costs are outweighed by benefits. This assumed positive net benefit is usually summarized by increases in (per capita) GNP.

Increases in (per capita) GNP in most models are, however, largely a logical result of two basic assumptions: the equality of net capital inflows to a presumed counterpart real capital formation, and capital-output ratios in the Harrod-Domar tradition. Additionally, they derive from the assumed diffusion of technical knowledge imparted by accompanying skilled personnel servicing the real capital thus transferred. There has been little effort to determine whether or not any increases in developing countries' (per capita) GNPs should actually be attributed to net capital inflows.

And so the benefits are stressed, while the costs to recipients, even of loans, are accorded scant attention. And when loan and direct investment costs are discussed, they are usually examined from the creditor's or investor's standpoint of evaluating the developing country's capacity to meet debt service and profit and dividend payments, as they become due.

<sup>5</sup> *Ibid.*, p. 314 f.

<sup>6</sup> Cf. John C. H. Fei, Gustav Ranis, *Development of the Labor Surplus Economy*, Homewood, Ill., 1964, and Louis Leifer, *Planning in a Surplus Labor Economy*, in: *American Economic Review*, June 1968, pp. 343 - 473.

<sup>7</sup> See, for instance, H. Myint, *The Economics of the Developing Countries*, New York 1965, chs. 1 - 3.

<sup>8</sup> John C. H. Fei, Douglas S. Paauw, *Foreign Assistance and Self-help: A Reappraisal of Development Finance*, in: *Review of Economics and Statistics*, August 1965, pp. 251 - 67.

<sup>9</sup> Hollis B. Chenery, Alan M. Strout, *Foreign Assistance and Economic Development*, in: *American Economic Review*, September 1966, pp. 679 - 733.

<sup>10</sup> The likelihood of a serious lag in employment growth, in spite of even outstanding performance in the two other areas, has been pointed out by Chandavarkar. Cf. Armand G. Chandavarkar, *More Growth - More Employment? A Challenge for Less Developed Countries*, in: *Finance and Development*, June 1972, pp. 28 - 35.

The costs of external borrowing are usually summed up in the phrase, "debt service burden", variously defined. However, long-term structural distortions, likely to result from *ad hoc* efforts to cope with this burden, viewed as either the saving problem, or the balance-of-payments problem, during external liquidity crises, are usually not included as costs. The fact that the effects of such distortions are difficult to quantify is not enough reason for omitting them entirely from discussions. However, mention is sometimes made of foregone economic growth, including the extreme possibility of a depression, arising from adjustments required in meeting these problems or, conversely, of growth which additional inflows in periods of liquidity crises could make possible.<sup>11</sup>

### Costs Implied by the Term Structure

Costs of loans, in terms of total resource outflow and structural distortions, depend highly on lending terms. The relatively large amortization and interest payments, and the bunching of maturities characteristic of short- and intermediate-term debt, all of which tend to exacerbate any foreign-exchange difficulties, create a natural preference among borrowing countries for "soft", long-term loans. Three main reasons account for this preference.

First, because the total debt service is thinly spread over a long period, long-term borrowing seeks to prevent external liquidity crises. Secondly, there is the assumption that income and export growth, to which long-term loans shall have contributed, would make their own amortization and interest payments relatively painless, unlike short- or intermediate-term loans. And, third, long-term debt affords the possibility of greater cost rationalization than short- or intermediate-term debt.

A loan is usually deemed to be economically transacted by a developing country, only if its economy's growth rate (or, in the project case, the rate of return) exceeds the applicable interest rate. Though still unsatisfactory, since external liquidity crises can still occur even when satisfied, this condition is usually not required of short- or intermediate-term loans. These consist of supplier's credit or contractor finance, or credits under compensatory financing. They are one of the principal sources of developing countries' external liquidity crises. In fact, contracting for them by a developing country suggests at least a budding balance-of-payments problem and a dearth of "softer" loans. Under such conditions, usually accompanied by stringent import and exchange controls, the normal economic rationalizations fade in importance, in the face of mounting threats of social and political instability.

Rationalization of the cost of long-term borrowing in terms of rates of overall economic growth or individual rates of return on specific projects cannot take account of further economic costs which may result from future aggravation of the foreign-exchange constraint problem. Economic growth does not by itself guarantee the growth of export revenues. On the other hand, increased imports are a more likely result.

So, if export revenues do not rise fast enough to cover expected increases in imports, in addition to debt charges plus profit and dividend payments, then future balance-of-payments difficulties will arise, irrespective of overall growth rates or rates of return on projects. Hence, under the rate-of-growth or rate-of-return rationalization conditions, problems could still arise during the development period and impose further costs on the economy, costs that may even derail the entire development programme.

One such problem is the need for debt refinancing. Amortization and interest payments become due at pre-stipulated points in time, irrespective of the prevailing foreign-exchange position of the debtor country. If these obligations are met by any new borrowing, the total amounts due are capitalized, as in the so-called "second mortgage problem". That is, the unamortized portion of the original principal and the remaining interest charges now become a new principal upon which a new, probably higher, interest rate is charged.

Thus, in such a situation, external debt liabilities tend to increase rapidly, raising the real resource cost of the original borrowing and the likelihood of further future foreign-exchange crises. And, if the new borrowing consists mainly of short- or medium-term liabilities, which are available frequently at prohibitive interest rates, the total resource costs and the costs of structural distortions from future external liquidity crises are likely to be quite high.

### Viciously Cumulative Debt

"A viciously cumulative debt burden"<sup>12</sup> emerges when debt growth indefinitely exceeds total output growth. This is most likely to occur and persist where emergency conditions cause a recapitalization of part of principal and capitalization of remaining interest, as outlined above. That is why compensatory financing and various types of refinancing schemes merely postpone already developing crises, and constitute a threat to the future external liquidity of developing countries.

<sup>11</sup> Cf. D. Avramovic et al., *Economic Growth and External Debt*, op. cit., p. 174 f.

<sup>12</sup> *Ibid.*, p. 172.

The economic costs, to the borrower, of the "viciously cumulative debt" are, again, quite high. They can be met, or rather postponed, by a fast-rising volume of new external borrowing, which only promises greater resource outflows in the future to meet the resulting mounting volume of debt service. The debt can soon become "unmanageable". In such circumstances, default becomes a most "economical" option. Even then, there would follow all the usual costs attending serious liquidity crises.

Analysis of external debt-servicing possibilities within the rate-of-growth and rate-of-return framework implicitly assumes that foreign-exchange revenues will grow at least as fast as output or profits. This need not be. A realistic analysis of external debt-servicing potential must consider, specifically, the relevant foreign-exchange variables. Thus the growth rate of total external financial obligations, of which debt may comprise a major part, should be compared to the growth rate of the export surplus, where the relevant imports are perhaps only those intended to meet basic consumption and development requirements.

The "viciously cumulative debt" could then be redefined as one whose growth rate exceeds indefinitely the growth rate of the export surplus. But most countries actually project large import surpluses in their development plans. Thus the chances that the "viciously cumulative debt", in this modified sense, does not emerge may depend largely on severe curtailment of imports for both consumption and investment. This still constitutes a cost in terms of present consumer welfare, and future growth of income, foregone.

### Debt Rescheduling

The "viciously cumulative" and the "unmanageable" debt can also be examined from the standpoint of what happens if the debtor country does not contemplate default. The debts are then rescheduled, with or without debt consolidation. Generally, there is the usual pressure from creditors for higher taxes and currency devaluation.

The taxation may reduce personal disposable incomes, but may not succeed in reducing imports appreciably, since substantial portions go to business firms and government. And the devaluation seldom works to increase the total value of exports for a developing country because international prices of primary commodities, its principal exports, are mainly exogenous to its economy and are hardly affected by domestic supply conditions. Moreover, devaluation, if successful in reducing export prices, may even lead to lower total revenue because of the characteristic price-inelastic demand.

So the major repercussions of debt rescheduling are domestic and adverse. They may be followed by quantitative and administrative import restrictions, growth retardation, and structural distortions. Meanwhile, service charges on the rescheduled debt soon become due again in the face of upward rigidities in export revenues. Thus the original crisis, temporarily suppressed by the rescheduling operation, is likely to re-emerge.

### Import Substitution

On the surface, it would seem that a development programme with a large import-substitution bias provides just the right solution to the foreign-exchange problem, and so obviates the necessity of generating large export surpluses to finance debt service. But, on closer look, we discover that it may even bring additional problems.

The building of an import-substitution structure requires, initially at least, considerable imports of capital equipment. Thus a heavy volume of external debt and equity ownership is likely to be created at the beginning, and may grow with the import-substitution sector. This sector, therefore, generally contributes heavily to external debt service, and profit and dividend outflows, even in the intermediate term.

It may be argued that, since one of the main objectives of this sector is to effect foreign-exchange savings, the debt service and other foreign factor payments would be more than offset by such savings. But the import-substitution sector usually requires recurrent imports of its own, consisting mainly of capital and intermediate goods.<sup>13</sup> Import substitution may not, therefore, appreciably reduce imports, except perhaps in the very long term. It may even increase imports in the short and intermediate terms.

### Re-appraisal Necessary

With all these possibilities of short- and long-term costs to developing countries receiving capital inflows, the preoccupation in the literature on the benefits to these countries and on their ability to meet resultant servicing requirements hardly seems justified. In particular, the importance accorded debt-servicing capacity analysis skirts the fundamental question of the costs of external borrowing in the development process. Our analysis above strongly suggests a thorough re-appraisal of the issue of external borrowing and other forms of policy-induced capital inflows for financing economic development.

<sup>13</sup> For a concise, but rather complete discussion of this issue see H.M.A. Onitiri, Recent Trends in Nigeria's Balance of Payments, in: *Nigerian Journal of Economic and Social Studies*, July 1965, pp. 145-57. A far more pessimistic and cautious view of the foreign-exchange saving and growth-generating potential of import substitution is presented by Jose A. Datas-Panero, Import Substitution, in: *Finance and Development*, September 1971, pp. 34-39.