EXTERNAL FINANCE AND BUDGET DEFICITS IN DEVELOPING COUNTRIES: A GENERAL SURVEY

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ABSTRACT

When a deliberate excess of expenditure over income is carried out by the government, it takes the form of a budgeted deficit, financed by borrowing, either from foreign sources or domestic sources. Usually, the anticipated objective is to stimulate economic activity and employment by injecting more purchasing power into the economy. Whereas there is evidence to show that there is negative relation between domestic savings on one hand and foreign borrowing on the other, the trend of the causation seems at least for the Tanzania case, to run from foreign borrowing to savings. The analysis from this paper recommends external financing (foreign borrowing) which can be viewed as a benefit cost question. Such borrowing, when carried out the net gain resources (present and future) should be balanced against the cost of debt servicing including repayment. Thus, a budgetary deficit financed through borrowing should be of a type that results in a net addition to national outlay or aggregate expenditure, otherwise external financing may not be a satisfactory way of dealing with budget deficits.

INTRODUCTION

External financing to developing countries is generally traced back to colonial links between Western imperial powers and overseas territories. The early literature on foreign finance and economic development was dominated by a large optimistic vision of the less developed countries. It was generally felt that aid and other capital flows to developing countries would induce an expansion of their economic activities and output. Conventional external finance theory has its origins in Keynesian economics, particular the theories of economic growth that writers like Keynes (1936) applied to industrialised economies. Kaleck (1933) shows the advantages of external finance for the development of a country, and argued that the process of development tends to strain the balance of payment by raising the requirements for import of capital goods as a result of higher investment for industrial raw materials (because of growing industrial production) and for food if home production lags behind demand. The function of external finance is to relieve the shortage of foreign exchange to meet these requirements.

There are major constraints inhibiting the successful injection of foreign capital and the acceleration of economic development pace. It is in increasing the investment rate to accelerate the process of economic growth that gives a critical role to economic foreign capital. Within the Hamold-Domor growth model, the investment rate of developing countries is raised by injections of foreign capital, so expanding the domestic saving rate without reducing the level of domestic consumption (Tripath, 1968). While foreign capital is not absolutely necessary to raise the level of investment, it speeds up the historical process of reaching the stage of self sustained growth.

REASONS FOR BORROWING

Foreign borrowing differs from domestic borrowing in that it gives the borrowing country command over more goods than it is currently producing. Hence external borrowing allows the government to finance itself without displacing household and the enterprise spending. However, the payment of interest on an external debt and the repayment of principal which require a transfer

of resources abroad rather than merely a reallocation of purchasing power among residents, 'drags' behind the development of the borrowers i.e. developing countries.

THE DUAL GAP ANALYSIS

The need for foreign borrowing can be viewed in the context of the Dual Gap analysis, thus dealing with the use of the external borrowing to supplement domestic resources to attain target growth rate. It gives foreign capital significant role (H.B. Chennery, 1960).

$$(1 + G) - (S + T) = (M - X) \qquad 1$$

The Equation (1) above states a fundamental relationship between a developing economy's resource gap and its foreign exchange gap. As long as the developing country is spending more on investment (1) and government expenditure (G) than it is earning from the domestic resources released through private savings (S) and taxation (T), then there will be a domestic resource gap that will spill over into the balance of payment, with imports (M) greater than exports (X). This follows from the national income analysis in which the uses of national income (C + I + G + X - M) must equal the disposal income (C + S + T). The internal imbalance in the resource gap is filled by imports being greater than exports in balance of trade. In other words, foreign resources are filling the domestic resources gap by allowing the excess of investment and government expenditures to be validated in real terms. The foreign exchange gap, however, must be filled by capital inflow from overseas, through official development assistance, commercial bank loans, or private excess of imports over exports plus interest payment on existing debt. The working out of the external debt will depend, in turn, on a reduction in the resource gap, lower interest rates, and a declining current account deficit.

The two gap analysis of the role of external aid is also significant in indicating that one gap may be greater than the other, exact; if for example, the foreign-exchange gap is greater than the saving gap, foreign aid becomes the means of permitting the required imports, so that the full saving potential can be realised and resources will not be left under utilised because of an import bottleneck.

The savings gap exists because of insufficient domestic savings to undertake intended investment. Thus foreign capital becomes a supplement to domestic savings. It is argued that domestic and foreign exchange savings are not perfect substitutes. Growth is limited by the need for necessary imports. Chennery (1966) emphasised on the gaps that the inflow of the two external resources as separate factors of production the effective use of which makes possible a rapid sustained development.

If exports and capital transfer are insufficient to use available domestic savings, domestic investments is limited by lack of foreign exchange. The gaps are not additive. The dual gap analysis is criticised because it assumes no substitution between domestic and foreign resources. It assumes developing countries have the absorptive capacity to use foreign capital. Excessive use of capital increase only consumption. It operates at a highly aggregated level, and since it allows structural constraints to be overcome in the short run, this may have adverse effect like increasing the consumption ratio. It encourages capital intensive projects thus increasing the capital/output ratio.

Development requires capital formation and that capital formation requires saving. Public investment which is financed by borrowing (domestic) does not add to capital formation if it merely deviates funds otherwise available for private investment. When borrowing from abroad, additional resources become available because the borrowing will be accompanied by increased imports. This borrowing provides additional financing for a given growth rate with a lower rate of tax and higher rate of current consumption. By the 1970's many developing countries relied on foreign borrowing to finance increasing public sector deficits. When the inflow of foreign capital dried up in the early 1980's some countries were able to reduce their fiscal deficits but many were not (World Bank, 1989). Foreign Capital inflow leads to a reduction in the rate of growth in GNP. Griffin and Enos (1970) regressed the average growth rate of twelve Latin American

countries on the ratio of aid to GNP for the period 1957-1964. They found that the coefficient of regression was negative. Their estimated equation was:

$$Y = 42.27 - 6.78 (A/Y); R^2 = 13 \text{-------------} (2)$$

BALANCE OF PAYMENTS

For many countries the current account of the balance of payments increase by only 2% p.a. of the GNP (World Bank, 1989). External debt service problems manifest themselves in current account deficit and foreign exchange shortages. When this occurs, difficulties may be of such magnitude as to require a restructuring of all or part of a country's debt stock. There is, however, a tendency on the part of both debtors and creditors to avoid renegotiation of original loan terms. Borrowers are aware that deviation from payment schedules damages their credit standings and tenders view rescheduling as at least a temporary impediment to their cash flows. Consequently, a nation may be already heavily in arrears before it elects to undergo the rescheduling at its debt. If allowed to continue without a successful rescheduling/refinancing accord being reached, debt service problems can lead to a unilateral moratorium on payment by the debtor, an outright repudiation of debtor, or a declaration of default by the creditor.

In the contemporary world, however, sanctions for international bankruptcy are severe. They almost certainly include the breaking of trade links upon which the nation normally relies, the denial of credits that are the lifeblood of trade, and in extreme cases a deliberate government-enforced trade boycott.

NEGATIVE FACTORS: INFLATION

The deficits in the balance of payment are accelerated by the increase in inflation rate (Dobb, 1951). It causes uncertainty and instability in relative prices, makes longer-term investments riskier and more difficult to finance. It also makes the future purchasing power of finance contracts less certain and even when interest rates are not regulated, uncertainty about future inflation make it hard for lenders and borrowers to agree upon appropriate fixed nominal interest rates. The lender risks inflation turning out higher than expected. The higher and more variable the inflation, and the longer the time horizon, the greater the risks.

The government of developing countries turned to their central banks because domestic financial markets were too shallow to meet their needs. To the extent that central banks financed such borrowing by issuing money, the result was higher inflation. The average inflation rate in developing countries raised from 10% a year in 1965-75 to 26% in 1974-82 and 51% in 1983-73. Half of all developed countries continue to enjoy single digit inflation, but the number of countries with double and triple-digit inflation has risen in recent years e.g. Argentina had inflation of 174.8% Nigeria 9.7%, Zaire 106.5% and Mexico 159.2%. The high inflation underscores the interrelation of external debt, and fiscal policy such as repeated devaluation and added inflationary pressures, but deficit financing has provided the primary impetus (World Bank, 1989).

The size of their debt in relation of GNP matters because it affects the liquidity position of the economy and of the investors holding it. When making foreign borrowing, one needs not reduce her/his expenditure. Outlays in the private sector resources needed for the public outlay are acquired abroad via an import surplus. Loan finance now imposes a burden on future generation by leaving it with reduced capital endowment at home but by saddling it with an obligation to service foreign debt (Boween W. G., Davis R. G. and Kopf D. H., 1962). Inflationary financing crates excessive demand for resources in the economy. In the context of the inelastic resource supply of resources in underdeveloped countries, there takes place a rise of prices; and although the rise of price is symptom and not the course of inflation, it is the mechanism by which the transfers of incomes take place either to private entrepreneurs or of the government. As argued by Lewis (1955), if it becomes excessive not only may voluntary saving be discouraged but the use of money as medium of exchange may be discouraged, involving society in real resource costs and welfare losses. Since inflation reduces

purchasing power, the money holders may be expected to avoid the loss by cutting down their holdings of money for transaction purposes (Maurice Dobb, 1951).

A high inflation rates, privates sector borrowers often find it too risky to take on purchasing power obligations, because they fear their income will fail to keep pace. The public sector, in contrast does not have this problem. It can go bankrupt in its domestic markets as long as it has power to print money. Thus at high inflation, most indexed contracts are issued or backed by government or public entities (W. A. Lewis, 1955).

POSITIVE FACTORS

As put forward by Thirwall (1994) there are some advantages of inflation, especially the ability of inflation to release resource for the development by the redistribution of income between classes within the private sector and from the private sector to the government. The real appreciation of the exchange rate favour production of non tradable over tradable goods, and encourage on imported inputs.

FOREIGN EXCHANGE RATES

Overvalued exchange rate and controlled interest rates combines to stimulate capital outflows. These flows were illegal in countries with foreign exchange controls, but such control have rarely been effective. Although capital flight is hard to measure, the discrepancies between increase in external debt and uses of finance recorded in the balance of payment account especially for many Latin America in the early 1980's point massive capital flight. For example capital outflows in the West African countries were massive in 1980's and the government faced severe liquidity problems because liabilities and assets rose much faster than wage linked incoming cash flow (World Bank, 1989).

Some countries including Turkey, Uruguay and Yugoslavia have adopted foreign currency deposit schemes. Since domestic value of the foreign exchange deposits are dominated in domestic currency, the bank lose with each devaluation of the interest rate and the differential is insufficient to cover the change in currency value. This puts pressure on the Central Bank to provide accommodation e.g. in Yugoslavia, Central Bank losses to the foreign currency deposit scheme have added to inflation pressures. (World Bank, 1989)

During the 1970's many developing countries allowed their exchange rates to appreciate in real terms. This was made possible by relatively favourable terms of trade and by availability of foreign loans to finance the resulting current account deficits. As an alternative to foreign borrowing as argued by Tripath (1968), meeting the resource gap, investment budget can be put into practice, as a more or less continuous process. He suggested two kinds of view namely concentrating on productive and quick yielding projects at the initial stage of development. He argued that gradual increase in 'Y', narrowing down of the non-monetised sector, and a gradual larger magnitude of domestic funds without excessive inflationary pressure may be incurred. Secondly, as a temporary sporadic measure to bridge the gap in invisible resources, so as to provide facilities for the development of basic overheads which require large resources for their implementation. Once the bottleneck are broken, the economy will proceed an its onward march of cumulative economic progress. (World Bank, 1989)

Mjema (1994) argued that the most plausible atmosphere where foreign aid could reduce the domestic savings of a recipient country, is when the recipient government in anticipation of inflows of foreign aid sets to deliberately lower its tax. In so doing the foreign aid recipient government reduces the domestic savings which could have been raised through taxation. The recipient government hopes that this domestic savings gap will be filled by the availability of foreign aid savings. Closely related to the tax effort, the recipient government can also alter the consumption habit towards more consumption in anticipation of an aid inflow. As argued by Griffin and Enos (1970) the availability of low interest loan to a recipient have an adverse impact of reducing the incentive to save by private sector. In this case if the share of the private sector saving

is large, the reduction in incentive to save in this sector could be detrimental to total domestic savings.

CONCLUSION

It is thus the income gain to domestic factors which renders foreign borrowing such an important instrument of developing policy. Capital import include the provision of foreign exchange and the collateral advantage gained from the introduction of advanced technology and managerial know how. It relaxes the savings constraint. It supplements the less developing countries low domestic savings, hence helping to fill the resource gap or savings gap and provides additional foreign exchange there by helping to fill the foreign exchange gap.

At the same time foreign borrowing has its risks, especially when the obligation of debt service exceed what can be accommodated within a country's balance of payment constraint. As an instrument of development, external finance is generally of limited value. It however often reflects macroeconomics constraints. It retards the development of domestic managerial talent. Foreign borrowing is benefit-cost issue for any government. As recommended by Goode, (1984) external borrowing is viewed in terms of a country's debt servicing capacity.

Even the obvious additions made by aid to national saving, foreign exchange and economic growth, hardly have any worth unless aid does lead recognisable benefits in economic development. Particularly highlighted, are effects on poverty alleviation and income and asset distribution. Institutional pessimists argue that the interplay of power and economic interest prevents these countries (developing) utilising the aid provided in a manner conducive to poverty alleviation in these countries.

Some theorists pinpoints the deficiencies of the state in the developing countries and the fundamental requirement of mobilising mass support as the key to meaningful development. They assert much aid is filtered away through corruption and that the aim of less developing countries (LCD's) rulers is not to relieve poverty but rather the contrary, to make sure that the incomes of the masses are kept low and social services are retarded. Foreign finance is part of a structural relationship between rich and poor countries which has evolved overtime to underdeveloped the later. The objectives of the developed are primarily to use the poor countries to further their own economic interest.

Governments in developing countries may voluntarily relax domestic efforts when more foreign aid is available than otherwise. The possibility also exists that some proportion of the foreign capital inflow may be devoted to uses with a small impact on economic growth (Hugg, 1993). Though borrowing abroad gives command over more goods and services than it is currently producing, but entails a future real cost and transfer problem. Whether such borrowing should be undertaken is essentially a benefit cost question that can be analysed by reference to the value of the financed expenditures and the country's debt services capacity which depends on the growth of output, export, and of imports. Budgetary deficit financed through borrowing should be of a type that results in a net addition to national outlay or aggregate expenditure, otherwise external financing may not be a satisfactory way of dealing with budget deficits.

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