

# The African Debt Dilemma: An Overview of Magnitude, Causes, Effects and Policy Options

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**Abstract:** This paper attempts to highlight the African debt dilemma. It tries to highlight empirically, the magnitude, causes and effects of African indebtedness that has grown several times between 19970 and 2007. It identifies factors responsible for African's debt to include excessive budget deficits, economic mismanagement, rising real interest rates in industrialized world, global oil shocks and commercial banks' lending practices of the 1970s. The paper concludes with some policy recommendations that are likely to help reduce Africa's huge external debt and its impacts on development; therefore, Africa's debt problem should be a joint effort by all participants. [Journal of American Science 2010;6(3):63-69]. (ISSN: 1545-1003).

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## I. Introduction

External indebtedness represents one of the greatest problems facing Sub-Saharan African countries in recent times. A more important issue relates to the impacts and the sustainability of this huge indebtedness, which is not only a burden to the present generation, but also a glaring tool for mortgaging the prospects of the future generations. Indeed, the literature is replete regarding the effects of this huge and growing indebtedness which includes capital flight, discouraging of private investment, erosion of hard earned foreign exchange from exports, etc (Ajayi, 1991).

The growing concern now centers around the welfare implications of the indebtedness, especially as they affect the poor, and especially the most vulnerable, namely women and children in particular. There are widely held views that debt related problems such as growing debt repayments are partly responsible for Africa's low growth, growing unemployment and poverty. Regrettably, most Least Developed Countries (LDCs) are now classified by their indebtedness (e.g. Highly Indebted Poor Countries HIPC, etc).

Equally important issue is the perpetuating nature of the LDCs external indebtedness, which makes it very difficult to understand. Ironically, Africa that is endowed with abundant human and natural resources is helplessly constrained by these debt problems regardless of several strategies prescribed by several agencies. This dilemma underscores the need for greater understanding of the issues involved in debt accumulation by the LDCs and the attendant impact

on poverty with a view to unravel the mysteries of debt-poverty nexus and consequently to proffer more workable situations to this problems.

This paper represents a modest attempt to provide further searchlight to the causes, magnitudes and effects of Africa's huge external indebtedness as well as possible policy options for reducing the indebtedness and consequently alleviating the growing poverty in Sub-Saharan Africa.

According to Todaro (1997), the accumulation of the external debt is a common phenomenon of the Third World countries at the stage of economic development where the supply of domestic savings is low/ current account payment deficits are high, and imports of capital are needed to augment domestic resources.

In the view of the Ajayi (1991), the external debt problem is becoming more acute for several reasons. First, there is the enormous growth of debt relative to the size of the economy, which cannot only lead to capital flight but also serve as a discouragement to private investment. Apart, from this, there is the concern relating to the associated huge debt servicing payments that tend to take away a significant portion of the annual savings.

As a result of the debt burden, the executions and the possible benefits of various adjustment programs in LDCs have been jeopardized, on addition to the crippling effect of debt management system on the output. To this extent, some scholars have attributed the relatively low growth in Africa to the effect of debt crises. For instance, World Bank (1986)

indicated the external indebtedness of African countries is an obstacle to the restoration of the conditions needed for growth. Regrettably, many African countries are now classified as heavily indebted countries. This is certainly a serious cause for concern.

The focus of this paper is to unravel the issues around Africa's indebtedness with a view to examine the causes, effects of these debt and the policy options for reducing the indebtedness and the attendant impact on poverty generally.

The rest of this paper is organised as follows: section II examines the magnitude of Africa's indebtedness generally. Conceptual and methodology issues around the LDCs debts are examined in section III. Section IV represents the empirical evidence of the causes and effects of the debt. We conclude with policy recommendation in section V.

## II. The Magnitude of LDC's Indebtedness

The size of external debt of LDCs was relatively smaller prior to the early 1970's. At this period, debt was mainly an official phenomenon. Creditors at this period comprised mainly of foreign governments and financial institution including the International Monetary Fund (IMF), the World Bank, and several regional development banks.

Understandably, most of these loans were on concessional terms, attracting relatively low interest rates. Such loans were in most cases not wisely spent on implementing specific development projects or even on expanding imports of capital goods (Todaro, 1997:506). However, the trend changes over time and the magnitude of loans grew by leaps and bounds especially within a decade. Table 1 shows the initial growth in LDCs loans between 1970 and early 1980s.

**Table 1: Long-Term Debt of LDCs by Source-selected years-(US\$ Billions)**

Sources	1970	1983	% Increase	No. of Increase
<b>1. Official Creditors</b>	<b>32</b>	<b>221</b>	<b>590</b>	<b>7</b>
Multilateral	7	80	1,042	11
Bilateral	25	141	464	6
World Bank	(2)	(37)	1,750	19
<b>2. Commercial Banks</b>	<b>20</b>	<b>335</b>	<b>1,575</b>	<b>17</b>
<b>3. All Sources</b>	<b>63</b>	<b>644</b>	<b>922</b>	<b>10</b>

Sources: World Bank, World Debt Tables 1989-90 Vol. 1 pp 378-379

From the above table, we can notice how loans from official creditors to LDCs grow 7 times between 1970 and 1983. Remarkably, loans from commercial banks expanded 17 times from US\$20 billion in 1970 to US\$335 billion in 1983, which represents more than half of LDCs debt. Table 2 represents Africa's total external debt between 1970 and 2007. It shows that Africa's external debt increased from US\$9.8 billion in 1970 to US\$123 billion in 1980, US\$288 in 1990 and about US\$195 billion in 2007. In other words, Africa's external debt grew more than ten times between 1970 and 1980 and almost three times between 1980 and 2007. Furthermore, a slight decrease is noticed in 2007 which is due to the debt cancellation or debt forgiveness which had been offered for LDCs by the creditors.

**Table 2: Africa Total External Debt and Debt Service (US\$ Millions)**

Debt Component	1970	1980	1990	2000	2007
Total External Debt	9,891	123,338	288,773	211,248	195,094
Total Debt Service	1,002	18,977	27,737	29,740	27,600

Source: ADB, African Development Reports, 1993, 2000, 2007.

As noted earlier, this increase in commercial bank loans resulted from the petrodollar from the wealthy oil exporters, which the commercial banks helped to channel to the middle-income developing countries for development purposes. If we relate the level of indebtedness to the level of the economy, we can see that the external debt as the percentage of GDP has also been on the increase. The same goes for the attendant debt-service as a proportion of the export earnings that raises the issue of sustainability of the debt (see table 3).

**Table 3: Africa: External Debt and Debt Burden Ratio (%) 1970-2007**

Debt Component	1970	1980	1990	2000	2007
Total External Debt	13	23.0	42.8	61.7	22.9
Total Debt Service	5.3	7.0	21.1	11.5	5.5

Source: ADB, 2007 African Development Report 2007

Table 3 shows that external debt as a ratio of GDP increased 5 times between 1970 and 2000. The same goes for the debt service as a percentage of export earnings. Meanwhile, as at 1970, the external debt of low-income countries stood at about US\$10 billion or

only 13% of GDP while the debt service ratio was only 5.3%. This has increased to about US\$853 billion in 2000 or about 60% of GDP, while the debt service as percentage of export earnings increased at a decreasing rate over the same period from 5.3% in 1970 to 5.5% in 2007.

**III. Conceptual Issues and Empirical Estimates of Causal Factors**

Krueger (1987) provided a discussion of both conceptual and practical problems involved in estimating foreign debt of developing countries. First, there is a concern about understanding the true rate of increase in debt. This is due to the fact that some exercise such as initial running down of reserves of sales or foreign assets are often not taken into consideration when estimating debt in LDCs. Other conceptual problems relate the effect of currency revaluation on debt outstanding, differences in terms of debt, inconsistencies of debt figures from official sources, or variety of debt reduction techniques.

On the other hand, Todaro (1997) contends that foreign borrowing may not necessarily be evil, but can even be beneficial such as, for instance, providing the resources required for promoting economic growth. The only consideration in this regard relates to the associated cost such as debt service. In most cases, debt service obligations are met through export earnings, curtailed imports or further external borrowing. In this way some difficulties may arise.

Beyond this, another important concept to be given attention when considering debt issues is the basic transfer. By definition, debt transfer refers to the net foreign exchange inflow as a relation to a country's international borrowing. By implication, basic transfer is the difference between the net capital inflow and interest payment on the existing accumulated debt. The basic transfer which captures the debt burden represents the amount of foreign exchange which a country gains or loses each year from international capital flows (Todaro, 1997). Painless to add that for LDCs, the net gain from foreign exchange represents an important component for stimulating or retarding their growth. Following Todaro (1997); we can represent the basic transfer equation as follows:

$$F_N = dD \dots\dots\dots 1$$

Where:

$F_N$  represents "Net Capital Inflow"

$d$  represents percentage rate of increase in total debt

$D$  represents total accumulated foreign debt.

We note that interest must be paid each year on the accumulated debt. It represents the average rate of interest as "r", the total annual interest payment becomes  $rD$ . The basic transfer (BT) equation then becomes:

$$BT = dD - rD = (d - r)D \dots\dots\dots 2$$

So when  $d > r$ , BT will be positive which implies that the country will be gaining. If on the other hand,  $r < d$ , the basic transfer will end up as negative. In this case, the country will be losing foreign exchange.

It is in the context above that one can better appreciate the condition of the LDCs who have been on the losing end arising from predominantly negative basic transfer over the years.

Indeed, the literature is replete on the causes and the effects of the debt crisis of the developing nations. For instance, Dornbusch and Fischer (1985) concluded that imprudent borrowing policies in the debtor countries and imprudent lending by commercial banks had a chance encounter with extraordinary unfavourable world macroeconomic conditions that exposed the vulnerability of the debtors and the creditors.

Ajayi (1991) contended that many creditors overstated the potential capabilities of the now debtor countries to meaningfully absorb and pay for debts. Similarly, he contended that the over-ambitious nature of many governments in LDCs to overly speed up the process of growth prompted by over-generous international creditors accounted for huge debt accumulation of these countries in LDCs.

Consequently, Guttentag and Hering (1985) blame the commercial lenders and their regulations for Africa's indebtedness. According to Cline (1985), the global macroeconomic condition is largely responsible for the growth in LDCs debt. On the other hand, Sachs (1985) highlights the role of global shock including country specific factors in expanding external debt accumulation of LDCs. Greane (1989) describes the causes of Sub-Saharan Africa's debt as emanating from external and internal factors. In all, factors identified as contributing to debt accumulation include:

- ❖ Excessive budget deficits
- ❖ Misaligned exchange rates (overvaluation)
- ❖ Economic mismanagement

- ❖ Deteriorating terms of trade
- ❖ Rising real interest rates
- ❖ Global oil shocks
- ❖ Liberal lending policies of international commercial banks, etc (Ajayi, 1991).

According to Gillis et al (1992), several of the borrowing countries were profligate with their resources and ignored principles of sound economic management. Furthermore, the oil shock of 1973-74 and 1978-80 caused major disruptions in the world economy. While oil importers had to adjust to lower standards of living, oil exporters had to manage massive new revenues productively. Many governments increased their spending and budget deficits. Inflation resulted in most cases with attendant result of overvalued exchange rates. Increase in price of imports and exports were restrained. This led to discouragement of export growth and encouragement of capital flight.

The advent of recycled petrodollars through the commercial banks boosted investment expenditure. Regrettably, most of the investments were wasteful and could not pay off debts. Indeed, the excess liquidity in commercial banks fueled by petrodollars found escape valves in developing countries that apparently were not ready for such funds in terms of clear vision as well as development mission. Indeed, the political immaturity in the 1970s left the governance of most African states in the hand of opportunists and selfish elites either in the military or semi-military civilian who are still trying to understand the art of governance.

On the part of the landing banks, because the debt was guaranteed by governments, bankers discounted risk of defaults. The United States government and international agencies encouraged lending with the hope that the liquidity of the early 1980s would disappear once the world economy recovers from its instability (Gills, et.al, 1992).

Revisiting the great debt crisis of 1982, Fishlow (1985) opined that the European debt crisis. As the money centers began to search out new prospects, they found a hitherto untapped clientele among the rapidly growing countries of the developing world. These countries were later christened new industrialized countries (NICs). They include Brazil, Korea and Mexico. Thus, capital began to flow to finance the increased imports required by these countries to accelerate their economic expansion. The experience has shown that most of these countries have moved from debt-led growth to growth-led debt. As we can see, in the process of development, most

LDCs became attracted to debt-financed adjustment possibly due to its “cheap cost”. Most of these countries enjoyed the luxury of borrowing to offset the rise in the oil prices having established prior links to the market. For most of the developing countries, they had to adjust painfully despite large official lending mobilized for them. The result is a wide gulf between middle income and the low-income countries in the 1970s (Fischer, 1985).

Beyond the explanation above, following Ajayi (1991), our empirical estimate utilizes the regression analysis to estimate the internal and external factors in the debt crisis. The model has the following general forms:

$$TED = f(OGD, IRS, TOT, IIR, OPR) \dots\dots 1$$

$$TDS = f(TED, OGD, IRS, TOT, IIR, OPR) \dots\dots 2$$

Where:

TED = total external debt

OGD = overall government deficit

IRS = international reserves

TOT = terms of trade

IIR = international interests rates

OPR = oil prices

TDS = total debt services

An increase in government deficit is expected to lead to an increase in total external especially provided the deficit is financed from external borrowing. Similarly, an increase in international reserves may induce growing debt with the tendency to encourage borrowing as outlet for the reserves. On the other hand, if the reserves are generated by LDCs, it may serve as the source of mobilizing resources without necessarily borrowing. An improvement in terms of trade is expected to reduce borrowing. The converse is also true. The same applies to international interests rates. An increase in interest rates will discourage borrowing on one hand and also worsen the debt service payments on the other. Oil price can also affect the trend in external borrowing in two ways. An increase in oil prices makes fund available for lending. On the other hand, its impact on relative prices also influences government expenditure and resource requirements.

In general, the overall government deficit has a significant bearing both on debt service and the total

external debt which probably shows that external debt of LDCs are primarily to finance growing fiscal deficits. However, the emerging patterns indicate that Africa's debt problem is a complex issue. Similarly, international reserves also positively negatively affect the total external debt. This probably shows that it is a sign of international prosperity and a strong incentive to borrow. Equally, the results regarding the international interest rates and oil prices agreed with our expectations. International interest rates were ridiculously low in the 80s thus encouraging huge borrowing. Notwithstanding, it affects debt service payments significantly later on. Since the terms of trade are generally unfavourable to LDCs, it negatively affects the growth of their external debt. The same goes for oil prices, which also induce heavy borrowing by LDCs and lending by industrial world. The goodness of fit of the equations is equally good.

#### IV. The Effect of Africa's Debt

An important issue relates to the effect of Africa's debt on the continent. In this context, debt servicing problem is of paramount importance. Three factors warrant attention here.

1. There is a question of increases in the interest burden, which often exceeds increase in the national income.
2. There is the issue debt as a proportion of national income rising.
3. The consideration of the ratio of debt service payments to export earnings.

Since debt-service payments are generally required in convertible currencies, they then became fixed charges on export earnings. Meanwhile, export earnings have a tendency to fluctuate. If care is not taken, debt-servicing payments may exceed new inflows from export earnings. This then becomes a more serious crisis (Thirlwall, 1983).

To highlight this problem further, we can notice from table 2 and 3 that debt service payment of most LDCs comprise around 20% of their export revenues. In fact, the total debt of Sub-Saharan Africa has grown steadily. It shrinks at \$21 billion in 2000, which is a little lower than 1980 levels and went further down at \$20 billion in 2007. Indeed, annual debt-service payment is almost four times Africa's annual expenditure on health and education combined. It is indeed a serious drain on Africa's already depleted development finance, (Todaro, 1997; Gardner, 1995 and Nafziger, 1993).

Given the trend around the world, it appears the debt crisis is far from being over. At best, it can be regarded as only sleeping. Most African countries with large burden of repayment have contended with a prescribed structural adjustment programs, following which their economic growth have turned negative, per capita income on the decline, and necessary to generate growth disappearing. Needless to add that infrastructure in most Sub-Saharan African countries saddled with heavy debt burden have become virtually non-existent. In addition, as a result of impoverishment of Africa by debt burden, the continent has also been contending with massive brain drain to the industrial nations.

As a result of the structural adjustment programs incorporating the liberalization of the financial system, which has the intend of promoting trade and competitiveness, domestic currencies of most Sub-Saharan African countries have depreciated rapidly. The net effect is that more and more domestic currencies have to be given up in the process servicing the huge debts, which on their own have also attracted higher dollar interest rates such as in 1987-1982 in the Unites States. Furthermore, of the crippling effect of the debt burden, there has been a considerable decline in LDCs export volume partly due to worldwide recession, and the attendant worsening terms of trade.

Recognizing the implications of the debt burden on LCDs in general, several proposals for relieving or restructuring the debt burden of high indebted poor countries have been made and are of common knowledge.

These include:

- ❖ Allocation of special drawing right to restructuring
- ❖ The 1989 Brady Olan which links partial debt forgiveness for selected borrowers to IMF or World Bank financial support upon LDCs commitment to adopt IMF-type adjustment programs.
- ❖ Debt-for-equity swaps though private investors (mostly foreign corporation).
- ❖ Debt-for-nature swap, intended to encourage LDC governments to be committed to environmental preservation.
- ❖ Debt rescheduling over a longer period, also called debt renegotiation.
- ❖ Conventional debt-buy-back
- ❖ Debt cancellation/forgiveness

In spite of the fact that some of the proposals above have been adopted, the Africa's debt burden still

remains a serious concern. It is in this context that one could explore some more inward-looking approaches to the reduction of Africa's indebtedness. This will be addressed in the concluding section.

## V. Conclusion

The fact remains that many highly indebted countries, especially those in Africa have found themselves engrossed in a vicious circle in which their economic growth have been sacrificed for the payment of debt. Regrettably, the sacrificed economic growth is expected to be sine-qua-non of escaping from the debt. Perhaps more worrisome is the view that the prevailing economic decline is almost becoming self perpetuated, to extend that a seemingly low level of living experienced in the late 1970s are becoming luxurious in recent times.

To start with, the time has arrived for the entire world (debtors and creditors) to see the global debt crises as a joint responsibility for one and all. The entire world economy will fare better if the world's economic playing field is leveled to an extent. As one Professor puts it, "The poor (debtor countries) cannot sleep because they are hungry. The rich (creditor countries) will not sleep because the poor are awake". So a crisis for one is a crisis for all.

Given the above, finding solution to Africa's debt problem should be a joint effort by all participants. To this extent, we will like to highlight the following policy options, which will be classified into two categories one for the creditor countries and the other for (debtor) African countries.

In line with the suggestions advanced by Todaro (1997) we like to submit as follows:

- ❖ The industrialized countries should reconsider their position to debt crisis in Africa and take appropriate action such as relaxing their restrictive monetary policies, which often acted against LDCs.
- ❖ As Africa attempts to promote exports, the industrialized countries will do better by increasing their imports from LDCs. In this regard, battlements and impediments in the forms of standardization, which basically discriminate against LDCs export, should be discarded with.
- ❖ There is also the need for further debt relief in the form of allowing interest payments of loans in local currency to hedge against rising dollar interest rates. Alternatively, putting a cap on real interest rates will go a

long way to provide some debt relief to LDCs.

- ❖ A relaxation of conditions for accessing financial support facility provided by the IMF and World Bank is also important for LDCs in order to promote the much desired economic growth required to be able to reduce their debt burden.

On the part of debtor countries, especially in Africa, the following suggestions will be in order.

- ❖ There is the need for African government to adapt sound economic management at various levels, this will go a long way to reduce excessive deficit financing arising from wasteful expenditure.
- ❖ Corruption plays a key role in debt crisis. It has often been alleged that most of the contractual multilateral loans found their way into personal accounts of some Government Officials abroad, while their nations contend with debt-service burden. Efforts should be targeted towards reducing corruption and increasing transparency in governments.
- ❖ There should also be renewed commitment by LDCs government to liquidate existing debt stocks as the earlier possible time through self-sacrificing prudent economic management.

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