POLICY BRIEF
2024-01-023, JANUARY 2024
ISSN # 2094-3342

De La Salle University
AKI
Angelo King Institute
for Economic and Business Studies

Developing countries and external debt: What is wrong?

Written by:

Jesus Felipe
Distinguished Professor, School of Economics
Director, Angelo King Institute
De La Salle University

Jose Antonio Perez Montiel
Associate Professor, Economics Department
University of the Balearic Islands, Spain

DLSU - Angelo King Institute for Economic and Business Studies
Room 223, St. La Salle Hall
2401 Taft Avenue, Manila, 0922, Philippines

Visit Us
https://www.dlsu-aki.com/

Developing countries and external debt: What is wrong?

By Jesus Felipe and Jose Antonio Perez Montiel

LAST DECEMBER, the World Bank published its annual report on international debt (*https://www.worldbank.org/en/programs/debt-statistics/idr/products*). The report indicates that, in 2022, the developing countries spent $443 billion on debt-service repayment (principal plus interest) of their external public and publicly guaranteed debt, 5% more than in 2021. These payments are expected to rise in 2023 and 2024 due to the increase in interest rates. The report indicates that debt levels and high interest rates have set many countries on a path to crisis.

The report provides data on total external debt, defined as debt owed to nonresidents repayable in currency, goods, or services. By debtor, total external debt is divided into three categories: (i) use of IMF credit and SDR allocations; (ii) long term external debt — this refers to original or extended maturity of more than one year, and it is divided in two types: (a) public and publicly guaranteed, and (b) private nonguaranteed long-term debt, and these two are owed to official (multilateral and bilateral) and private creditors —; and (iii) short-term debt. Short-term debt includes all debt (public and private) having an original maturity of one year or less and interest in arrears on long-term debt. Data are shown in current US dollars.

For the Philippines (*https://datatopics.worldbank.org/debt/ids/countryanalytical/PHL*), the data indicates that, in 2022, total external debt had increased to $111 billion (about P6.1 trillion). Slightly over 80% was long-term external debt and the rest was short term (IMF credit represented a negligible percentage). Of the $91 billion in long-term debt, 69% was public debt (56% owed to public creditors and 44% to private creditors). This means that the share of private nonguaranteed debt represented 31%. In 2022, the Philippines debt-service repayment amounted to almost $9 billion, of which 63% corresponded to principal repayments (37% was interest); and the external debt to exports ratio (total external debt stocks to exports of goods, services and primary income) was 99.3%, while debt service represented 8% of total exports.

The World Bank's data are not identical to that provided by the Philippine Treasury on national debt (*https://www.treasury.gov.ph/wp-content/uploads/2023/02/NG-Debt-Press-Release-December-2022-ed.pdf*). In 2022, Philippine national debt, amounted to about P13.4 trillion. This includes both peso-denominated debt (domestic debt, essentially government securities) and foreign-denominated debt (external debt). The latter accounted for about 31% of the total, that is, Philippine foreign debt amounted to about P4.2 trillion, or about $76 billion. Forty-five percent of the external debt are loans and the other 55% government securities in different currencies — mostly US dollars.

This figure is significantly lower than that provided by the World Bank. The reason is that the multilateral institution considers debt servicing (repayment of principal and interest), while the Philippine government does not — it only considers the stock of debt. The World Bank also includes as debt that of the private sector but not the Philippine government (only government debt).

With this background on the data, the question is why many developing countries face problems honoring their foreign debt payments. We will argue that the Sword of Damocles that the developing countries face is that all their international transactions are run in a currency different from their own: US dollars. It has become a headache for many of them to obtain dollars and manage them properly.

Both the public and private sectors of developing countries need foreign currency. The private sector needs to import essentials such as capital goods (for example, machinery), food, and oil. Governments also need foreign currency because part of their payments may contain an import component. These countries also probably import weapons for their defense forces (which are necessary) and luxurious consumer goods (probably not necessary) that have to be paid in dollars.

Developing countries obtain dollars through exports of goods and services, through remittances, or by securing a loan or by issuing debt (securities) in a foreign currency. It is the latter that has to be repaid — the Damocles Sword. Many developing countries run current account deficits (imports outstrip exports) quasi-permanently. This has to do with both the fact that some of their imports are dubious (for example, luxurious goods) and with the fact that their exports are mostly agricultural products and simple manufactures. It is very difficult for them to secure loans in a foreign currency (because lenders deem them risky), or for their governments to issue debt in a foreign currency (beyond a certain level, nobody wants to buy those securities). When the domestic economy cannot supply the goods and services needed, and imports must be reduced due to the lack of dollars to pay for them, the economy ends up collapsing. This has happened on many occasions, the latest victims being Argentina, Pakistan, and Sri Lanka.

Developing countries are then forced to borrow the foreign currency (dollars) from multilateral institutions such as the IMF, the World Bank, or the Asian Development Bank because, despite these institutions' conditions, they offer funds at low interest rates. Obtaining these dollars avoids the significant currency depreciations that developing countries have to endure.

The need to avoid a permanent current account deficit imposes a macroeconomic constraint on growth on many developing countries. The reason is that they have to curtail import growth to that consistent with their export growth. This then determines the output growth rate consistent with current account equilibrium. It is known as the balance-of-payments-constrained growth rate. This growth rate is lower than the country's potential growth.

The World Bank's report claims that, to repay foreign debt, developing countries have to "shift scarce resources away from public health, education, the environment, and infrastructure." What are the scarce resources the statement refers to? A significant portion of the expenditures on health (build a health center, pay doctors), education (build a school, pay teachers' salaries), and infrastructure (materials to build a road and construction workers' wages), "should be" in the domestic currency, pesos in the case of the Philippines. The domestic currency certainly is not a scarce resource. However, advanced complex equipment, medicines, and even steel, have to be imported and paid for in dollars. Dollars are a scarce resource for most developing countries because they have to be earned.

The issue at stake is that those developing countries that have to fund most of their expenditures to build schools, hospitals, or roads in dollars are in very bad shape. It means they do not have a domestic industry (that would use the domestic currency) that can supply the basic materials to build them. This is the real problem.

The report indicates that developing countries face the choice of servicing their public debt or investing in public health, education, and infrastructure. This choice should only occur if they finance their expenditures in dollars. This situation, the report continues, warrants quick and coordinated action by debtor governments, private and official creditors, and multilateral financial institutions — more transparency, better debt sustainability tools, and swifter restructuring arrangements.

Developing countries should not face such a choice. Surely coordination is needed. Yet, given that this is a recurring story, the solution to these countries' problems lies in helping them change the structure of production; and not in restructuring their foreign debt with more foreign debt. We know the result: another crisis. These nations need to create a domestic industry capable of supplying all necessary goods for the nation to function. This should be the government's priority number one, and this is what the multilateral institutions should help them do.

This is not to blame multilateral agencies: developing countries' original sin is that they often get into trouble because of their own policy mistakes. The problem gets compounded when they borrow foreign-currency, and this snowballs because it is not repaid. The domestic industries they have to create to break this vicious cycle should be able to supply the domestic market and to export to earn dollars to pay for the necessary imports (for hospitals and to build roads). This is the essence of what development is about.

The Philippines is by no means in a precarious situation. National domestic debt (in pesos), about P9.2 trillion, is not a problem. The Philippine government will always be able to honor this debt because it is in the nation's currency (unless for political reasons it decides to stop payments). The argument that the "government does not have money" (its own currency) to build schools, hospitals, etc. (except what must be imported) is incorrect. Foreign debt is a different story for the reasons explained above. Yet, the most recommendable strategy for the Philippines is to also upgrade the structure of its economy. This is the nation's perennial problem.