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Role of Debt Crises on the Economy of Developing Countries

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ABSTRACT: This study researched on the causes, current effects and potential implication of the debt crisis of developing countries. Two developing countries, Pakistan and Bangladesh selected from Asia which are tested in terms of sustainability of their debts. The debt crisis found as a result of factors including inflation, investment and exports. Most of the economies of underdeveloped countries have fallen into double dip recession. Developing Economies with sever debt distress have moved deeper in inflation and are caught into downward twisting dynamics from high external debt and internal debts. Economic growth of most of under developing countries has decelerated internal confronts and external defenselessness. Economies of under developed countries are going through another round of rough territories. Right after an economic havoc that originated in the Asia, the Developing economy is experiencing debt crisis.

Key words: Internal debts, External debts, Liquidity problems, Investment, Exports, Inflation, Developing economy

1.0 INTRODUCTION

In this era where every field of life is rapidly growing and developing, it is too difficult rather impossible for a country to finance all developing expenditures with its own resources. So to cop up with this problem of insufficient revenue for expenditure, the country borrows money from internal as well as from external resources. In certain limits this practice is normal, but during last few decades it has been noticed that debts are growing extraordinary in all countries generally but particularly in under developed countries. The rationale of this research is to elaborate the impact of debt crises on the economy of developing countries. Recent crises in developing countries have demonstrated the weakness of real sectors to changes in financial market conditions. Better management of government's balance sheet may significantly decrease the frequency of debt crises. The outbreak of the developing countries debt crises has realized to the people that immense increase in public debt has turned out a serious problem. The burden for the governments has remarkably increased for the developing countries, since 1970s. Under developed countries have tendency of

easily affected by debt crises which has been seen in the recession of 1980s to 1990s. This damage brought severe crisis to economy of developing countries.
In 1986 nearly 40 of the developing countries were forced to default due to their debt payments.
So by the economic point of view there emerges a question need to be asked: is the government of under developed countries implementing a sustainable debt policy after experience of debt crises? Government debts are identified by duration until these are repaid.
There are three kinds of debts that affect economy:

- Long term debts
- Short term debts
- Medium term debts

Long term debts are usually having time span of ten years.
Short term debts are usually having time span of one year or less than one year.
Whereas medium term debts are in between of long term and medium term debts.
It is well known that rise in interest rate have pronounced effect on developing economies. As debt crises follow by rise in interest rates and fall in export earnings. An economic growth rate plays a role in debt dynamics. But real word of public debt crises focuses on budget deficit neglecting the role of economic growth. Slowdown in economic growth is strongly associated with rising debt ratios of all under developed countries. In this research paper economic impact of debt crises of developing countries is solely focused. The factors effecting economic growth are inflation, exports and investments which are effected by internal debts and external debts problems. Investment is the channel through which economic growth affects by public debt.
The debt can be repaid in full if there is availability of sources of external funding on temporary basis. Now a day the external debt situation of under developed countries remains a source of economic distress. A number of under developing countries have overcome first phase of Balance of Payment (BOP) crises but their debt problems still have to be resolve. The developing countries have to utilize all its available resources for fund raising to implement its developing plans. For economic growth these countries have to utilize all its surplus and tax revenues and in addition it should seek for internal and external debts. In developing countries level of savings is too low there for these countries have to borrow it from abroad. There are two dimensions of foreign debts, positive and negative. Positive dimension is that it is helpful in the process of economic development while as negative dimension is that borrowing in excess can cause serious problems for developing countries. Investment is necessary for developing countries Sometimes, unavailability of foreign aid became problem for developing countries. On the other hand, external debt converts into wealth when the loans are repaid with the interest. External debt exerts direct burden on the economy of developing countries because of increase in taxes by the government for generating additional revenues for the debt payments. There is a fact that debts are to be paid from future income so it reduces future savings. In under developed countries, strategy makers and international organizations give more importance to external debts as compare to internal debts. When government borrows internally, they utilize internal private savings; on the other hand it may keep on hand for lending in private sector. Sequentially, a small residual pool of debt available to promote the capital cost in the market for private borrowers, resulting in demand of private investment and economic growth (Diamond, 1965). Given that Euro zone economies form the single largest destination for Bangladeshi exports, it seems inevitable that Bangladesh will be negatively impacted by the crisis. This sentiment was expressed by World Trade Organization (WTO) Director General Pascal Lamy, who mentioned during his visit to Dhaka in May, 2012: "… Macro-economic development for countries like Bangladesh, whose two-third of exports depends on Europe, is not looking very good".
The reason behind establishment of internal debt in under developed countries is, it stimulates the expansion of liquid internal financial markets by protecting countries from unfavorable external distress, and to eliminate

the risk of foreign exchange (Del, 2003; Aizenman, 2004; Kumhof, 2005). Inflation is a channel through which internal debt can be reduced. As Reinhart and Sbrancia (2011) indicated that inflation could particularly be an effective way to decline internal-currency debts. To understand debt problems of under developed countries and to observe what challenges they face, the problem has to be examined from the viewpoints of various factors. The current research highlights the most recent problems (internal debt, external debt, exports, investment problems and inflations) of debt crises of under developed countries and what these countries have done and still need to do to improve the situation of economic growth.

2.0 LITRATURE REVIEW

Numerous researches by using different variables, have explored the role of debt on economic growth of developing countries, few of them had ended up finding negative impact of debt on economic growth while other studies do not find main relationship between economic growth and debts. But the findings of these studies are varied. The period since 1982 was represented as debt overhanging period. However due to economic changes it has been made necessary to carry out additional studies to make use of most recent data. A brief explanation and some background of the variables used in this research are summarized here.

2.1 DOMESTIC DEBTS

Domestic debt known as internal debt is creation of money which government borrows, instead of printing cash. Government creates internal debts in the form of treasury securities or central bank's securities. Due to the rise in debt-servicing costs on domestic debt, the rise in world interest rates exerts direct pressures on government budgets. By increasing world rates, domestic debt experiences a rise in interest rates in under developed countries. Domestic debt has great influence on the underdeveloped countries economic growth. Waheed (2006) accomplished that there is deficit in policies of developing countries so this deficit has to be eliminated by domestic debts. Abbas, Christensen, & J.E. (2007) have concluded that 35% of bank deposits domestic debts decrease economic growth of developing countries. Through inflation, domestic debts can be reduced as Reinhart and Sbrancia (2011) says that particularly inflation can be an effective way to reduce debt of internal currency. While as another research indicates that Domestic or Internal debts viewed as more expensive as associated to concessionary external financing (Burguet, 1998).

H1: Domestic debts negatively impact investment, exports and inflation.

H2: Domestic debts have negative significance on economic growth of developing countries.

2.2. EXTERNAL DEBTS

External debts also called foreign debts. It is part of country's total debts that are payable to foreign creditors. The government, corporations or citizens of that country can be the debtors. External debt is the forms of hidden debt. Debt negatively effects the economic growth Cunningham (1993). Countries that are heavily indebted have to face debt overhang problem since their external debts exceeds the expected present value of the future returns Sawada (1994). Many other studies such as choudhury (2001), Siddiqui and Malik (2001), Easterly (1999, 2001 and 2002) and Sen (2007) have concluded their research on same results that the external debts have negative impact on economic growth. External debt is an important indicator of overall weakness. External debt is an important indicator in crises as the borders between public and private debts became indistinct Reinhart and Rogoff (2009, 2011). Today the situation of external debts is a base for serious concern in under developed countries. The trouble for the heavily indebted underdeveloped countries is that they are far away from being resolved. Overall external debts do not have negative impact on economic growth (Chowdhury 1994).

H3: External debts influence investment, exports and inflation.

H4: External debts have both negative and positive influence on economic growth of developing countries.

2.3. INVESTMENT

Putting money into asset is called investment with expectations of appreciation in capital, dividends or interest earnings. At early stage under developed countries have little stock of capital and limited investment opportunities. By defending bank balance sheet and profitability, domestic debts could be put into risky private investments (Barjas 1999; 2000)Foreign debt will further increase the domestic investment, if it is used for capital investment, because increase in aggregate supply will balance the increase in aggregate demand which is caused by increase in income. In contrast to it increase in expenditures on non-productive projects will results in higher interest rates which will decrease incentives for investments.

H5: Increase in investment on non-productive projects results in decrease in economic growth of developing countries.

2.4. EXPORTS

Export means shipping goods/services out of the port of the country. Exports have influence on economic growth of the country as Warner (1992) indicates the reason of the decline investment in many of the in debt and developing countries is declining exports prices. The meaning of down fall of commodity prices and exports is that under developing countries are facing decrease in Exports revenue. External debt is more than 160% of exports to debt level growth increasing and growth decreasing then on average (Patillo 2002). Another research indicates that foreign debt in rupees increase directly by devaluation if exports remain undeveloped and result in spectacular increase in debt burden decrease in economic growth and increase in poverty level (Anwar 2004). It's favorable for developing countries to create diversification in exports to deal with debt problems.

H6: Debts have negative impacts on exports that result in decrease in economic growth.

2.5. INFLATION

Inflation is referred as a general increase in level of price of goods and services over a period of time in an economy. The effects of inflation on economic growth are dramatic and various and can be positive or negative at the same time. Inflation became critical in order to capture the impact of uncertainty created by debts. Inflation can be measure through various indicators. Generally consumer price index CPI and GDP deflator are used as indicators of inflation. There is negative relation between inflation and economic growth and he further concluded that inflation obstructs the efficient resource allocation by obscuring the signaling role of relative price change, Fisher (1993). Some other researches support this concept that this negative relationship of inflation and economic growth appears only when rates of inflation beat some threshold Bruno and Easterly (1998) and Bullard and Keating (1995). By using a large sample from 1960-90 covering more than 100 countries, another study favors this negative concept of inflation and economic growth if a certain number of characteristics are held constant, Barro (1995). While other study of Li (2006) found no linear association between inflation and investment by studying 27 developed and 90 underdeveloped countries over the period 1961 to 2004. He concluded that the investment efficiency is a way through which inflation effects growth non-linearly and adversely.

H7: Under certain circumstances the effect of inflation on growth may be positive or negative.

2.6. ECONOMIC GROWTH

The increase in the market value of goods and services over a period of time is referred to as Economic Growth and it is usually measured as the percentage in real Gross Domestic Product (GDP). Over the last two decades numerous studies has dealt with the relationship between debt and economic growth. Debt has negative effect on economic growth of developing countries (Cunningham 1993). External debts negatively effects economic growth, a conclusion founded by Chowdhury (2001), Siddiqui and Malik (2001), easterly

(1999, 2001 and 2002) and Sen (2007). Latter on Fosu (1999), argued that the negative relationship between debt and Economic growth is the result of poor performance of recipient country. While some of the studies are against this concept as researchers concluded that overall external debts do not have any negative impact on economic growth (Chowdhury 1994). External debts and inflation hinders economic growth at the same time as real exports have positive effect on Economic Growth (Mohamed 2005). Hameed *et al.* (2008) explored the dynamic effect of debt servicing on the economic growth of Pakistan for the period of 1997-2003. He extracted the result that external debt servicing has negative impact on capital productivity which finally hinders Economic growth.

3.0 PROPOSED MODEL

Figure No. 1

4.0. RESEARCH METHODOLOGY

The recent study is expressive in its nature which means to explain something such as any fact or situation. The developed hypothesis expressing the reflecting existing situation as data consist on current years, these hypotheses are developed on analysis the impact of debt crises on developing countries.

4.1. SAMPLE/DATA

The results of this study are based on selection of data of two underdeveloped countries named Pakistan and Bangladesh. Four year data is collected from websites of “STATE BANK OF PAKISTAN” and “THE BANK OF BANGLADESH” for understanding the impact of debts on economic growth and development of underdeveloped countries. Convenience sampling technique is used in this research analysis that collects information from sampling of units of study that is available conveniently.

4.2. INSTRUMENTS AND MEASURES

The instruments used in this research define major purpose to examine whether debt have any significant effect on the economic growth of developing countries. The data is collected on latent variables that are vital in current research. These variables include Domestic debts, External debts, Investments, Exports, Inflation and economic growth of developing countries. The developed study based on the past data, past literature and current economic data of developing countries. In the sentence structure below the get file command is used to load data into SPSS. By default, SPSS does a pair vise deletion of those values which are missing. The meaning of it is, as long as both of the variables in correlation have valid value for case, that case is included in correlation.

The variables of this study are adopted from previous studies as shown in the table below.

Table No. 1

No.	**Variables**	**Hypothesis**	**References**
1-	Domestic debts	H1: Domestic debts negatively impact investment, exports and inflation.	Waheed (2006), Abbas (2007), Sbrancia (2011),

		H2: Domestic debts have negative significance on economic growth of developing countries.	(Burguet, 1998).
2-	External debts	H3: External debts influence investment, exports and inflation. H4: External debts have both negative and positive influence on economic growth of developing countries.	Cunningham (1993), Sawada (1994), Chowdhury (2001), Siddiqui and Malik (2001), Easterly (1999, 2001 and 2002) and Sen (2007), Reinhart and Rogoff (2009, 2011), Chowdhury (1994).
3-	Investments	H5: Increase in investment on non-productive projects results in decrease in economic growth of developing countries.	(Barajas 1999; 2000)
4-	Exports	H6: Debts have negative impacts on exports that result in decrease in economic growth.	Warner (1992), Patillo (2002), Anwar (2004)
5-	Inflation	H7: Under certain circumstances the effect of inflation on growth may be positive or negative.	Fisher (1993), Bruno and Easterly (1998), Bullard and Keating (1995), Barro (1995), Li (2006).
6-	Economic growth	Nil	Cunningham (1993), Chowdhury (2001), Siddiqui and Malik (2001), Easterly (1999, 2001 and 2002), Sen (2007), Fosu (1999), Chowdhury (1994), Mohamed (2005) and Hameed et al. (2008).

4.3 PROCEDURE

The data is collected from 2010 to 2013 from the websites of central banks of PAKISTAN and Bangladesh bank. After selecting, the data is coded and entered into SPSS sheet for Bivariate correlation analysis.

4.4 RELIABILITY ANALYSIS

The result of Bivariate correlation analysis measures the strengths and direction of the linear relationship between the two variables. It ranges from -1 to +1.

-1 indicates a perfect negative correlation and +1 indicates a perfect positive correlation

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If the result of correlation is more then 0.5, indicates significant effect of one variable on other variable. When result of Pearson correlation is 0 to 0.5 than there is weak relationship between two variables we can say that change in one variable is not correlated with change in other variable.

5.0. RESULTS AND ANALYSIS

5.1 HYPOTHESIS TESTING

The results of Pearson analysis are shown in the table below

Table No. 2

Sr. N0.	**Variables relation**	**Pearson Correlation**	
		Pakistan	**Bangladesh**
1-	**Domestic debt and Investment**	0.658	-0.875
2-	**Domestic debt and exports**	-0.420	0.725
3-	**Domestic debt and Inflation**	-0.792	-0.402
4-	**Domestic debt and Economic Growth**	-0.710	-0.675
5-	**External debt and Investment**	0.098	-0.041
6-	**External debt and Exports**	0.723	0.058
7-	**External debt and Inflation**	0.953	-0.663
8-	**External debt and Economic Growth**	0.390	0.576
9-	**Investment and Economic Growth**	-0.704	0.300
10-	**Exports and Economic Growth**	0.291	-0.090
11-	**Inflation and Economic Growth**	0.650	0.203

5.1.1 Domestic debt and Investment

Correlation analysis results of Bangladesh economy (-0.875) show that there is negative relation between domestic debts and inflation. If domestic debt increases then investment will decreases and vice versa but results of analysis of Pakistan shows significant correlation (0.658).

5.1.2 Domestic debt and Exports

Pearson correlation result of Pakistan shows that there is highly negative relation (-0.420) between domestic debts and exports. While as results of Bangladesh shows positive effects with correlation of 0.725.

5.1.3 Domestic debt and Inflation

Correlation result for Pakistan and Bangladesh are -0.792 and -0.402 respectively shows negative relation between domestic debts and inflation.

5.1.4 Domestic debt and Economic Growth

Overall results of impact of domestic debts on Economic Growth show that there is negative relation with Pearson correlation of -0.710 and 0.675 for Pakistan and Bangladesh respectively. So hypothesis HI and H2 are proven by the results of this study.

5.1.5 External debt and Investment

Correlation estimates results shows that external debts are significantly related with investment. There is a significant negative correlation between external debt and investment with correlation 0.098 and -0.041 for Pakistan and Bangladesh respectively. So these results support H3.

5.1.6 External debt and Exports

These results of correlation analysis of Pakistan show that the relation between external debts and exports is significantly positive but for those of Bangladesh there is a weak correlation. So these results support H3.

5.1.7 External debt and Inflation

Correlation analysis shows that there is positive significance between external debts and inflation but results of Bangladesh shows strong negative impact on external debts on inflation with Bivariate correlation results of -0.663.

5.1.8 External debt and Economic Growth

If results are greater than .5 than it is said to be significant positive but correlation analysis of Pakistan shows that there is weak relation between external debt and Economic Growth with Pearson correlation of 0.390 but economic analysis of Bangladesh economy shows significant positive influence of external debts and economic growth. Overall these results are validating H4.

5.1.9 Investment and Economic Growth

Correlation analysis of investment on economic growth shows strong negative results as regards to Pakistan with correlation -0.704 while result of Bangladesh shows weak positive relation between investment and economic growth. Overall if we compare both results of correlation we can say that investment does not have positive influence on economic growth if it is on nonproductive projects so these results are validating H5.

5.1.10 Exports and Economic Growth

Correlation result of Pakistan shows that there is weak positive relation between exports and economic growth with results of 0.291 and negative correlation with results of -0.090 for Bangladesh the result of this study supports H6.

5.1.11 Inflation and Economic Growth

Results show that inflation in Pakistan has significant positive effect on economic growth with Pearson correlation of 0.650 and of Bangladesh is 0.208 that is a weak positive relation. So these positive results show that inflation has positive impact on economic growth that supports H7.

Pakistan

Table N0. 3

Correlations							
		DD	**ED**	**Investment**	**Exports**	**Inflation**	**GDP**
DD	Pearson Correlation	1	-.665	.658	-.420	-.792	-.710
	Sig. (2-tailed)		.335	.342	.580	.208	.290
	N	4	4	4	4	4	4

ED	Pearson Correlation	-.665	1	.098	.723	.953*	.390
	Sig. (2-tailed)	.335		.902	.277	.047	.610
	N	4	4	4	4	4	4
Investment	Pearson Correlation	.658	.098	1	-.005	-.161	-.704
	Sig. (2-tailed)	.342	.902		.995	.839	.296
	N	4	4	4	4	4	4
Exports	Pearson Correlation	-.420	.723	-.005	1	.820	.709
	Sig. (2-tailed)	.580	.277	.995		.180	.291
	N	4	4	4	4	4	4
Inflation	Pearson Correlation	-.792	.953*	-.161	.820	1	.650
	Sig. (2-tailed)	.208	.047	.839	.180		.350
	N	4	4	4	4	4	4
GDP	Pearson Correlation	-.710	.390	-.704	.709	.650	1
	Sig. (2-tailed)	.290	.610	.296	.291	.350	
	N	4	4	4	4	4	4
***. Correlation is significant at the 0.05 level (2-tailed).**							

Bangladesh

Table No. 4

Correlations							
		DD	**ED**	**Investment**	**Exports**	**Inflation**	**GDP**
DD	Pearson Correlation	1	-.059	-.875	.725	-.402	-.675
	Sig. (2-tailed)		.941	.125	.275	.598	.325
	N	4	4	4	4	4	4
ED	Pearson Correlation	-.059	1	-.041	.058	-.663	.576
	Sig. (2-tailed)	.941		.959	.942	.337	.424
	N	4	4	4	4	4	4
Investment	Pearson Correlation	-.875	-.041	1	-.967*	.129	.300
	Sig. (2-tailed)	.125	.959		.033	.871	.700
	N	4	4	4	4	4	4
Exports	Pearson Correlation	.725	.058	-.967*	1	.052	-.090
	Sig. (2-tailed)	.275	.942	.033		.948	.910
	N	4	4	4	4	4	4
Inflation	Pearson Correlation	-.402	-.663	.129	.052	1	.208
	Sig. (2-tailed)	.598	.337	.871	.948		.792

	N	4	4	4	4	4	4
GDP	Pearson Correlation	-.675	.576	.300	-.090	.208	1
	Sig. (2-tailed)	.325	.424	.700	.910	.792	
	N	4	4	4	4	4	4
***. Correlation is significant at the 0.05 level (2-tailed).**							

6.0. DISCUSSION

If debts are more than the ability of repayment in future then the expected debt services will be an increasing function of output level of countries. So, return from domestic economy should be taxed by external investors and creditors from both domestic and abroad get hindrance to invest and economic growth effects adversely. This is called debt overhanging. Correlation results found negative impact of domestic debts on investment. But external debts have weak positive influence on economic growth (GDP) of under developing countries (UDCs). Problem of debt overhanging does not exist in Bangladesh. The obtained results of external debts is reasonable as it is related to productive activities with the increase of external debts, more capital accumulation takes place that promotes economic growth. The capital could increase by increasing debts whether these are external or internal, then the part of this capital used as investment for productive projects that results in economic growth of country.

By these findings it is indicated that Bangladesh has more capacity to borrow debts as compare to Pakistan. From the correlation analysis significant positive and negative results of debts have been extracted. Besides the thrush hold level there seems decline in debts repayment capacity. Increase in debts results in increase in debt services payment. External debts potentially effects economic growth by crowding out private investment. High internal debt service is one of the key obstacles to meet economic growth of UDCs. Correlation analysis shows that debts have both the positive and negative influence on economic growth of developing countries. For budget deficit of the government the debt is accepted for development of the economy by developing countries. Debts are less noteworthy as its effects exceed the positive effects to economic growth. But UDCs could get optimum benefit of debt by utilizing it in best possible way.

7.0. CONCLUSION AND RECOMMENDATIONS

This paper investigates the impact of debts on economy of developing countries and there revealed a sophisticated result that indicates debt interests and debts services have negative while those of debts have favorable impact on economic growth of developing countries. For growth there is need of debt, but it should be used and its interest payment should be in careful way. In recommendations of this paper some policies are provided to get rid of bad effects of debts. The debt policy should be strong and effective. The saving and investment gap should be eliminated. The excess savings should invested properly it will act as alternative for debts. For getting escape from external debts investment in human resource is the best source. Government of UDCs should have to interfere in international market of exports. This study analysis the effect of five factors (Domestic debts, External debts, Investments, Exports and Inflation) on Economic growth (GDP) for the purpose to examine the impact of debt crises on UDCs. Economic growth is measured in Gross Domestic Product (GDP). This study on Pakistan founds that external debts, exports and inflation have positive effect on GDP while those of domestic debts and investment have negative impact on GDP. In case of Bangladesh, the results are generated that factors such as external debts, inflation and investment have positive effect but other two factors (Exports and Domestic debts) have negative impact on GDP.

In context to recommendations according to this research, Pakistan involves in external debts as external debts have positive influence on GDP, so the government can utilize these debts on productive plans to increase the GDP. It should involve private sectors in project implementations to maximize the benefit by using foreign debts. UDCs should improve their monetary policy by implementing strong infrastructure. A strengthen domestic financial system should recognize to sustain the amount of public debts. Inflation is still unbridled and its risk is becoming a drag on GDP. It should be control because high inflation creates hindrance to Economic Growth and causes un-employment and reducing the living standard of low and fixed income groups. There is a risk that investment might be deterred with the spikes in interest rates and results in slow down of Domestic sector credit growth. To expand the growth UDCs should diversify their exports and should focus on economic indicators and statistics. UDCs should give priority on exports of diversified products rather than dependence on single product export economy. By focusing on these factors the pace of Economic Growth would be faster in UDCs.

8.0. Limitations

The limitation of this study is the economic data of only two underdeveloped countries (Pakistan and Bangladesh) is analyzed and entered in SPSS software for generating results. The data of recent four years from 2010-2013 have been analyzed; it is too short of this study. If more under developing countries selected and data more than four years selected than more accurate and consistent results could be generated. Another limitation was that the research duration was too short. If sufficient time provided for this research than there were chances to include more results of past researches.

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