

IB Economics

Section 4 Development Economics

Worksheet 4.7.1

The role of international debt

Foreign debt

Foreign debt and its consequences

- Outline the meaning of foreign debt and explain why countries borrow from foreign creditors.

Foreign debt: The outstanding debts of a country's public and private sector debts, owed to foreign governments, banks, international institutions.

Purchase of government bonds by domestic consumers are NOT included.

E.g. Japan has a large national debt but most of it is owed to domestic firms so it is not foreign debt.

Richer countries are getting richer and poor countries are getting poorer as lower income countries have to pay interest on their debt, thus increasing the poverty gap. This would happen if the initial loan taken by the poorer country is not used to increase production potential.

Examples of countries that spend a relatively large proportion of their GDP on interest payments are Mongolia, Kenya, and Sri Lanka

Why poorer countries borrow from foreign creditors?

The oil crisis in 1973, doubled the price of oil. Thus LEDCs which are usually importers of oil had large current account deficits which they had to finance through taking foreign loans as their population had low incomes meaning that they can't purchase government bonds, etc.

-inability to access international markets (as commodities are heavily protected) leads to a current account deficit. +terms of trade deteriorates as commodities as a low YED

- Loans would also be in US dollars, and because LEDC has a current account deficit this would lead to a depreciation in their currency, which means the value of their debt increases.

- Inflation in the west led to incentives for interest rates to increase (contractionary monetary policy) which further increases interest payments for LEDCs. (the late 1970s from early 1970s)

- Explain that in some cases countries have become heavily indebted, requiring rescheduling of the debt payments and/or conditional assistance from international organizations, including the IMF and the World Bank.

In the west, many agencies tried to cancel the loans owed by LEDC to foreign institutions. This, however, would encourage countries to get into debt and they would not spend the loan wisely. Because of this, it was decided that rescheduling the debt would be the better option.

Heavily indebted Poor Countries Initiative

An initiative by the world bank and IMF to grant debt reliefs to the poorest of countries with the largest percentage of debt. The countries that were chosen for this debt relief had to have a debt greater than 150% of the value of their exports. However, the countries just above this debt rate did not get the debt relief and thus were left behind.

Explain why the servicing of international debt causes the balance of payments problems and has an opportunity cost in terms of foregone spending on development objectives.

If countries have to pay interest rates on their debt they would have less money to spend on development projects such as infrastructure, education, etc. Furthermore, the interest payments are outflows from the economy thus it may lead to a balance of payments deficit.

- Explain that the burden of debt has led to pressure to cancel the debt of heavily indebted countries.

Jubilee 2000 and other NGO such as OXFAM put a lot of pressure and western governments and foreign banks to cancel the debt. Thus LEDC debt now is much lower than before.