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The Debt Crisis in the LDCs: A Case Study of Tanzania

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creditor s' resources have been used to fund debt buy-backs of commercial debt in low-income countries at heavy discounts. The Brady initiative also brought about other market -based solutions to the debt crisis, including debt securitisation, debt swaps (for cash, equity and the environment). Within this framework, the Debt Conversion Programme (DCP) was introduced in Tanzania in January 1990, with formal operations beginning in January 1991. The objectives of the DCP were to reduce the country's external debt and promote investments in selected priority areas, without undermining monetary stability.

5.0 The HIPC Debt Initiative

Even with sound economic policies and full use of the present mechanisms for rescheduling and debt reduction, along with the continued provision of consessional financing, there are still a number of countries which are not expected to reach sustainable levels of manageable debt within reasonable time horizons. To deal with this problem, the **IMF** and the World Bank have jointly put in place, in September 1996, the **HIPC** Debt Initiative. This initiative aims at reducing the debt burdens of the **HIPCs** countries to sustainable levels, with the condition that they adopt and pursue programmes of adjustment and reform in a consistent and prudential manner.

Sustainable debt levels under the initiative will be defined on a case-by-case basis within the ranges of 200 to 250 percent for debt-to-export ratio and 20-25 percent for the ratio for debt service oriented exports. It is unlikely that Tanzania will qualify under these terms. Thus, the following challenges arise:

(i) Implement fully the three year **ESAF** Programme;

(ii) Pay on time all debts due to the Paris Club

1.0 Introduction

In the mid-1980s the deteriorating financial situation in a number of least developed countries reached its critical climax. The ability of the **LDCs** to service their debts weakened and most of them failed to honour their outstandings. As a result, the **LDCs** were subjected to severe credit restraints. This position is reflected in rising debt/**GNP** and debt/export ratios. In spite of economic reforms, the debt situation has remained largely unchanged to-date. Out of the total 54 **LDCs**, 32 of them, which includes Tanzania, are presently under the category of severely indebted low income countries (**SILIC**). The main factors behind this debt crisis include: high interest rates, weak commodity prices, unstable oil prices, and restrictive trade arrangements.

In an attempt to address the debt crisis, a number of negotiations between the debtors and the creditors have taken place and various instruments aimed at resolving or alleviating the crisis have been used to little avail. Thus the debt crisis persists, and this condition undermines the economic growth of the **LDCs**. In this light, these countries are finding it hard to restore creditworthiness particularly at the level of international commercial banking lending.

2.0 The Role of Foreign Debt

External debt is eased as an economic problem where the following conditions prevail:

- debt borrowing is well understood.
- source of cheap credit is secured.
- there is a well structured debt servicing arrangement.

- borrowed funds are used for productive or production-enhancing investments.

- there exists a good cooperation framework for the economic entities operating within the debt market.

3.0 Debt Market Conditions

The literature on debt management tends to assume that the debt market is perfectly competitive. In such a market, a large number of borrowers compete for funds in the same way as a large number of lenders also compete for sound clients. It is assumed that the participants in the market have perfect knowledge and information on everything about the market. In addition, all economic actors are viewed to be rational and that each actor aims at maximizing a positive return on cost of capital. In this context, where a debt crisis occurs, both creditors and debtors carry burdensome consequences. If this were not the case, the debt market would be imperfect.

Under perfect market conditions, the demand for debt will be directly related to market interest rates(r), the price of commodities(P), **GDP**, the price of imports (Q), the exchange rate (V), and the wealth of creditor countries (W). Therefore, the debt market demand function D(t) could be summarized as below:

$D(t) = d\ (r, P, GDP,\ Q, V, W).$

Empirically, the demand for debt is negatively correlated to interest rates (r) and positively to income (**GDP**). Likewise, the price of imports (Q), the exchange rate (V) and the wealth of the creditor country (W) together negatively affect **GDP** and the export earnings of the debtor countries.

Tanzania attended the Paris Club meetings for the third time in 1990 and the same "Toronto Terms" were applied. Debts amounting to **USD** 199.4 million were rescheduled under Paris Club III, while **USD** 18.7 million were cancelled.

In late 1991, the Paris Club creditors introduced "Enhanced Toronto Terms" also named the "London Terms" and increased the level of debt relief on eligible debt in NPV terms to 50 percent. Debts worth **USD** 518.7 million and **USD** 182.8 million were rescheduled and cancelled, respectively, under Paris Club IV.

Despite all these concessional measures, however, Tanzania's debt has been growing and debt servicing ratios have remained very high. The debt repayment obligation represents a big drain not only on foreign exchange resources but also on the Government budget considering the fact that about 97 percent of the debt is directly owed by the Government. Tanzania therefore required additional debt relief in order to relieve its budgetary pressure and to enable the Government to allocate more resources to the social sector.

In this context, in late 1994, the Paris Club creditors increased the level of concessionality to 67 percent of eligible debt, in **NPV** terms, under the "Naples Terms", which also contained a "goodwill clause" embodying stock-of-debt relief to provide for possibilities for the **HIPCs** to "exit rescheduling". This particular debt relief significantly reduced the level of Tanzania's debt service obligation and resulted in greater relief to budgetary pressure.

Following the Brady initiative, which was designed to encourage more commercial creditors to discount their loans to developing countries, the World Bank's and some bilateral the Paris Club, Tanzania has made substantial progress in normalising relations. Hence, between 1978 and 1992, this group of creditors cancelled about **USD** 1.0 billion worth of **ODA** debt to Tanzania, and have also, from that time, provided additional assistance to the country mainly through grants and consessional loans.

4.2.3 Paris Club Rescheduling Arrangements

In the early 1980s, the Paris Club creditors provided debt rescheduling arrangements to the **LDCs** on non-concessional terms. The terms provided for a short repayment grace period (maximum 5 years) and short maturity periods (10 years), and market interest rates.

At the time of the Study, Tanzania had attended the Paris Club Meetings five times since the on-set of the **ERP** in 1986. Tanzania's first rescheduling, which took place in 1986, involved 97.5% of the country's outstandings which matured between 1st October 1986 and 30th September, 1987 (inclusive of arrears outstanding as of 30th September, 1986). Total debts consolidated and rescheduled under Paris Club I amounted to **USD** 1,046 million. However, the rescheduling exercise ended-up increasing the stock of debt for Tanzania.

In late 1988, the Paris Club creditors agreed to introduce an element of concessionality in their rescheduling terms for the **LDCs**. These terms were referred to as the "Toronto Terms". Thus, Tanzania's second Paris Club rescheduling (1988), was based on the "Toronto Terms," and affected debts maturing between 1st January, 1989 and 30th June, 1989 as well as arrears of eligible debt outstanding as at 31st December, 1988. Debts amounting to **USD** 372.9 million were rescheduled under Paris Club II while **USD** 22.3 million were cancelled.

3.1 Factors Determining Ability to Service Debt

A set of three factors determine whether or not debt servicing would not be problematic.

The first set of factors are those related to the terms under which the external debt is contracted. These include:

- interest charged on foreign borrowing;
- maturity and cash flow profiles;
- currencies in which liabilities are denominated;
- risk-sharing between debt and equity;
- the level and composition of a country's reserves.

The second sets of factors are those associated with the absorptive capacities of debtor countries. These include:

- levels of technological development;
- institutional capacities;
- legal framework;
- domestic resource availability;
- level of political maturity.

The third factor is the state of the domestic economic environment which the borrowing country has to face during the repayment period. If the environment is not conducive, the ability to repay would weaken.

3.2 Origins of the Debt Crisis

The debt crisis of the 1980s is explained by both external and domestic factors.

These include:

- temporary high commodity prices and trade booms which led to increased foreign income earnings which, in turn, leveraged borrowing credibility.

- availability of cheap loans and credits abroad, particularly in the 1970s.

- expensive expenditure programmes in developing countries.

- huge expansion of the state-owned sector of the economy in the 1970s which did not perform with excellence.

3.3 Debt Crisis: Some Solutions

3.3.1 "Pay Back, Continue" Approach

Given that the **GDP** growth rate in the **LDCs** is low, the starting point for addressing the debt crisis is through negotiation. This should be an on-going exercise. The players in the "Debt Game" may choose to adopt "Pay Back and Continue" strategy. This approach entails debtors honouring their obligations and thereby transferring resources to the creditor countries. In consequence, the creditors will, after evaluating the present creditworthiness of debtors, re-transfer more capital resources to the **LDCs**.

3.3.2 "Not Pay Continue" Approach

If the "Not Pay, Continue" approach is adopted, the debtors would transfer very little to the creditors. Trade will hence trying to address the situation in the context of the bilateral and multilateral mechanisms for debt relief to the **HIPCs** offered by creditor nations and the international financial community. It may be appreciated, in this context, that the creditors introduced and implemented a wide range of instruments since the early 1980s in order to address the debt burden of low-income countries. At the national level, Tanzania has introduced economic management measures directed at reducing the debt burden. These measures have centred on reducing the fiscal deficit through a cash budget system, strict non-borrowing from the banking sector, reducing government expenditure, particularly involving capital works outlays, and closure, liquidation and privatisation of state-owned assets.

4.2.1 Stabilisation and Economic Reform Programmes

Multilateral creditors, namely the IMF, the World Bank and regional development banks, have assisted debtor countries to address the debt problem through the design and implementation of adjustment and structural reform programmes which they have supported through consessional loans. As a result, over the past decade, multilateral financing to the **HIPCs** has increased. At the same time, the borrowing terms and conditions have significantly improved. In the case of Tanzania, the share of multilateral debt in total debt disbursed and outstanding has been increasing, reaching 31.3 percent in 1990 and 47.1 percent in 1996.

4.2.2. ODA Debt Forgiveness and New Concessional Financing Terms

There has been very little progress in normalising relations between the **HIPCs** and the official creditors outside the Paris Club. However, with respect to bilateral creditors belonging to

The best option under the present circumstances is "Pay, Continue" since the role of debt is to distribute wealth over time and from one generation to another. The implication is that the debtor society sacrifices for the development of its future generations.

4.0 The Tanzanian Case Study

4.1 The Causes of the Debt Crisis

The debt crisis experienced since the early 1980s was a direct result of:

- rapid growth in debt that was not matched by a corresponding increase in exports;
- the bulk of the borrowed funds being directed to projects that neither reduced the import requirements of the country nor increased the country's capacity to export and achieve competitiveness;
- weak institutional set-up of the economy in the inappropriate macro-economic policies that encouraged fiscal deficits and loss of external competitiveness.

It is significant to note that, precisely because of the nature of the institutional set-up of economy, the debt crisis in Tanzania is not only a balance of payments crisis but a fiscal crisis as well.

4.2 Tanzania's Response to the Debt Crisis

In response to the crisis, Tanzania has since the late 1970s been concentrate on basic consumption commodities as doors to foreign capital for investments and technology acquisition would be closed. An economic relationship impasse would develop, affecting, in its wake, even the normal bilateral aid that has flowed to assist poverty reduction.

3.3.3 "Pay Back, Stop"

The third option could be "Pay Back, Stop". In this strategy the debtor countries continue to honour their outstandings quite effectively and thereby transferring financial resources to the developed countries. Creditor countries may thence stop new outflows of capital to the LDCs within the framework of a lesson, namely, once bitten twice shy. It is a case of erosion of confidence on the part of the creditor nations.

3.3.4 "Not Pay, Stop" Approach

Another option could be "Not Pay, Stop". This will entail both parties reducing and finally stopping the transfer of resources over time and across nations. In order to survive, debtor countries will merely transfer minimum resources for the purpose of meeting their most basic consumption needs. Adoption of this path is tantamount to debtors and creditors losing sight of the objective of long run economic development and the need to sustain international economic solidarity.

The "Not Pay, Stop" option is the most pessimistic approach. It automatically precipitates a negative reaction of creditor countries leading to a complete stop in lending. Its implication is that the debt crisis will deepen rather than slow down and it may even induce global economic recession. In the end, it is the LDCs that would suffer more gravely from the consequences of this outcome.