EXPLORING THE NEXUS BETWEEN EXTERNAL DEBT MANAGEMENT AND ECONOMIC GROWTH
Arit Edet-Nkpubre
aritedetnkpubre@yahoo.com

Abstract
Numerous studies have been carried out to examine the relationship between external debt and economic growth; external debt and economic development; institutions and economic growth; but little or no attention has been made to simultaneously explore the relationship between external debt, institutions, economic growth and economic development. This paper focuses on that neglected aspect by exploring the relationship between economic growth and development; external debt and economic growth; institutions and economic growth and ultimately external debt management and economic growth.

Keywords: External debt, External debt management, Institutions, Economic growth, Economic development.

Introduction
Every country has goals to achieve. Some of the predominant goals include improving its citizen’s standard of living, increasing its economic growth and developing its economy. To achieve these goals requires resources. However, the scarcity of these resources and the law of comparative advantage often forces countries to depend on one another for the finance required for the pursuit for higher economic growth and sustainable economic development (Adepoju et al 2007). This dependence through the collection of financial resources is what is referred to as external borrowing. Hameed et al (2008) explain that external borrowing may help to accelerate economic growth especially when domestic financial resources are inadequate. Studies by Sulaiman and Azeez (2012) state that no government is an island on its own and it would require aid so as to perform efficiently and effectively.

Generally, Ajayi (1991) divides the causes of external debt into external and internal factors. The external factors include the cumulative impact of the world price shocks which resulted in expansionary fiscal policy which necessitated heavy borrowing to close the fiscal gap, decline in the terms of trade and liberal lending policies of the international commercial banks. The domestic factors include excessive monetary expansion and consequent inflation, excessive reliance on external sources of funding, over-valued exchange rates and poor project profiles. Other general causes of the external debt burden include accumulating principal, interests, payment arrears and penalties, corruption and inefficient loan utilization. Other general causes of the external debt problem in a country include inappropriate domestic macroeconomic policies and political instability which also plays a major role in retarding the debtor nations’ ability to grow out of debt burden, creating uncertainty, which compounds the problem of business planning and production (Iyoha, 1999). The majority of these causes of the debt problem could be generalized under the title bad debt management.

Debt management is commonly considered as a program or policy that helps the debtor in acquiring and clearing off their debts. "Sovereign debt management is the process of establishing and executing a strategy for managing the government's debt in order to raise the required amount of funding, achieve its risk and cost objectives, and to
meet any other sovereign debt management goals the government may have set, such as developing and maintaining an efficient market for government securities" (International Monetary Fund and World Bank, 2001, p.2). For effective debt management, the relevant institutions have a role of ensuring that a clear legal framework and structure is well established. The degree of institutional development is a fundamental factor in economic development and poor macroeconomic policies are often the symptoms of poor institutions (Acemoglu et al., 2002; 2004 cited in Nabi and Drine, 2009, p.1). The studies that focus on debt or aid effectiveness and economic development usually under emphasise the role that institutions play. Research carried out by Imbs and Ranciere (2005 cited in Nabi and Drine, 2009, p.1), for example, found that countries with good policies and good institutions have lower debt overhang. So it can be inferred that countries with good debt management policies will have a better chance at developing institutions with high quality in terms of achieving its functions.

In previous years, there has been a proliferation of research focused on the external debt and economic growth issue. The nexus between external debt and economic growth has increasingly become a topic of interest and even after being examined extensively, there is still a debate as to whether external debt stimulates economic or retards growth. Various studies have either concluded that external debt has no effect, a positive effect or both a positive role and a negative role in shaping economic growth.

Schclarek (2004) examines at a panel consisting of 59 developing and 24 industrialized countries and concludes that, for the developing countries, there is always a negative and significant relationship between total external debt and economic growth. This is a opposite to the findings of Patillo et al (2002; 2004) which concludes that at low levels, total external debt affects economic growth positively, while at high levels, this relationship becomes negative. In Schclarek’s (2004) case, there is no evidence of a positive relationship between total external debt and growth at low debt levels and he maintains that the external debt and growth relationship is negative at all levels. Many authors have reached similar conclusions to Schclarek (2004) that external debt has a negative effect on economic growth (Cunningham, 1993; Deshpande, 1997; Ezeabasili 2011) and some claim that the negative effect is through the decrease in investment (Sawada, 1994; Iyoha, 1999; Kutivadze 2011).

This negative relationship is often accredited to “debt overhang”, which is defined as the situation in which the expected repayment on external debt falls short of the contractual value of debt, and therefore expected debt service is likely to be an increasing function of the country’s output level (Krugman 1988; Diallo 2009). The high debt servicing costs can be translated to resources that could otherwise be used to develop the economy being paid to the creditors and this acts as a burden on the fiscal situation of the country and the performance of its economy. Debt overhang can be observed when large debt accumulation of a developing nation acts as a deterrent to the growth process since benefits obtained from growth are constrained by huge debt serving requirements as well as creating a disincentive effect for investment. Debt burden may depress investment, and hence economic growth, through illiquidity and disincentive effects (Onah 1994 cited in Oke and Sulaiman, 2012, p.3). The illiquidity effect stems from the struggle to allocate scare resources between consumption, investment and external transfer to service.
the existing debt and the disincentive effect are due to the expectations of future burdens which tend to discourage current investment. This disincentive effect could discourage domestic investment, as the high debt service payments may discourage efforts by the government to carry out structural investments and fiscal reforms that could strengthen the country’s economic growth and fiscal positions. Indeed, a government whose financial position is improving almost inevitably finds itself under increasing pressure to pay its creditors. The disincentive could discourage foreign investment, as debt overhang involves the accumulation of a large stock of debt that threatens the country’s ability to repay its past loan thus, the debt overhang increases the investors uncertainty about the country’s ability to pay and this lack of creditworthiness is a disincentive to invest which, therefore, depresses economic growth.

This paper contributes to the previous works in several important respects. First, it will look at external debt and growth but with particular attention on the external debt management aspect from 2 aspects: the debt level and servicing part; the debt institution part.

The majority of the literature mentioned above is concerned with the level of debt stock when looking at the relationship with growth. Most studies assign a high debt stock as negative when in reality it is the high rate of debt service, which comes with the high debt stock that negatively affects the economy. The external debt issue arises via the external debt service payments made on the external debt stock, so it is reasonable to conclude that a large external debt service payment imposes some constraints on the growth prospect as the finances used for the settlement of debts drains the country’s limited resources and curtails financial resources that would otherwise have been used for domestic developmental needs. This study will be concerned with the debt service capacity as well as the size of the debt. the size of the debt covers the problems that arise with the uncertainty that lies in the ability of the country to sustain the debt level and the debt service deals with the problem of how payments would be made from current incomes.

"While a great deal of attention has been paid to the size, structure, repayment profile, and economic impact of Nigeria’s debt, until recently relatively little attention has been accorded to the institutional arrangements for proper management of the debt. Yet, institutional arrangement and governance structures, or the lack thereof, can themselves significantly affect the size and structure of a country’s debt and its economic development in general" (Okonjo-Iwela et al 2003). This study will attempt to bring to light the neglected aspect of the external debt management institutional effects on growth and development.

This study will focus on the effects of external debt management on economic development and it will accomplish this by investigating the effects on economic growth as economic growth has been seen as an important indicator of development. The majority of the authors agree that growth is necessary to put countries on the path of development so we can look at economic growth as a prerequisite to achieve economic development. A poor countries economic growth is usually a precondition to it's meet development goals like poverty alleviation, development is not necessarily the same as growth so if growth is a necessary condition for development in poor countries, it is not a sufficient condition (Smith 2003). This paper will also briefly differentiate both terms to help understand our results.
External Debt
Debt has been defined in various ways but it basically refers to the idea that it is regarded as an obligation enforceable by legal action to pay money to another party or to make payment on which one person legally owes to another. Ezeabasili et al (2011) define debt as a contract in which the holder is obliged to fulfil the stated obligations along with accruing interest. Adepoju et al (2007) states that debt is created by the act of borrowing. The need for borrowing is brought about by insufficient funds, which the dual gap analysis clearly captures.

Several Studies (Ajayi and Oke 2012; Amin and Audu; Ayadi and Ayadi) capture the dual gap model of (Chenery and Strout 1966) to help illustrate the theoretical foundation associated with the role of foreign borrowing in the development process. The dual gap model involves the foreign exchange gap and the investment-saving gap. the foreign exchange gap arises when a country's balance of payment on current account deficit is greater than the value of capital inflows, which could also mean that the inflows of foreign exchange are too small to finance the imports of capital goods needed by the country (Bender and Lowenstein 2005). The investment – saving gap, according to Peter et al (2012) is the gap between the amount of investment necessary to attain a certain rate of growth and the available domestic savings. in order words, the gap arises when the domestic savings rate is less than the investment required to achieve the targeted growth. Akpan et al imply that foreign borrowing in essence has dual roles in development process as it increases resources available for investment by supplementing domestic savings or it adds to foreign exchange resources by supplementing export earnings.

Countries, especially developing ones, experience fiscal deficits which leads the government to borrow to finance public goods that increase welfare and promote economic growth. Ahmed (2008) defines external debt as all external obligations of a maturity of one year or more and outstanding at a particular point in time and payable in terms of reserves currency or goods and services. External debt has been defined in various ways (Ahmed and Shakur 2011, Oleksandr 2003) but as the term suggests, it is debt from an external source and can be generally defined as the outstanding payment required which constitute of the principal and interest by the debtor at some point in the future and are owed to non-residents by the residents of an economy.

External Debt management
According to Ojo (1997), external debt management may be defined as policy which seeks to alter the stock, composition, structure and terms of debt with a view to maintaining at any given time, a sustainable level of debt service payment. It has become an important issue in macroeconomic management. It involves the planned acquisition, deployment and retirement of external loans drawn either for developmental purposes or for balance of payments accommodation. Obadan (1997) considers external debt management to include; estimate of foreign exchange earnings, sources of external finance, projected returns from the investment the loans has financed, the repayment schedule and debt service burden; choice of debt instruments, the amount to be borrowed and the currency composition and the terms of the debt service; an assessment of the country’s capacity to service existing debt and a judgment as to the desirability or otherwise of contracting further loans. Thus,
external debt management is a continuous operation.

External debt management refers to the gamut of institutional and technical arrangements involved in organising the external liabilities of a country so that the debt service burden is kept within sustainable level (Ajayi, 2001). A country's debt level is sustainable if the country is expected to meet its current and future external debt-service obligations in full, without recourse to debt relief, rescheduling of debts, or the accumulation of arrears, and without unduly compromising growth (Emilia and Emilian 2007). The technical aspect is concerned with the determination of the amount (level) of debt the economy can sustain and that the conditions of borrowing are on favourable terms and are consistent with the future debt servicing capacity. While, the institutional aspect include the administrative, organisational, legislative, accounting and monitoring aspects of managing both the new borrowings and old stock of debt.

The nexus between growth and development
The debate concerning the economic growth and economic development exist in it's definition and indicators which have been clarified over time due to the conception of various theories that border on the issue.

Conventionally, the terms Economic Growth and Economic Development were used as substitutes when referring to the increase in Gross National Product or Gross National Product per capita. However, the continuous study of the terms have led various studies (Schumpeter 1911, Hicks 1969, Kindleberger 1958) to provide a clear distinction between Economic Growth and Economic Development.

The distinction between the terms have been in the way each term is defined and its measurement indicators. In terms of its definition, Economic growth is mostly defined as a narrow concept. Diallo (2007) defined economic growth as an increase in the production of goods and services in an economy at a given period, particularly over a long period. Economic development, on the other hand is mostly defined as a broad concept. One of the early definitions of economic development is by Todaro (1997) who defines the term as an increase in living standards, improvement in self-esteem needs and freedom from oppression as well as a greater choice. According to Smith (2003) the meeting of the basic needs, reduction in absolute poverty, the creation of modern employment opportunities and the achievement of an equal distribution of income have all become important criteria in determining the level of development. A clear distinction between both terms is seen in the definition by Schumpeter (1961) which states that development is a discontinuous and spontaneous change in the stationary state which forever alters and displaces the equilibrium state previously existing while growth is a gradual and steady change in the long run which comes about by general increase in rate of saving and population in a dynamic economy.

Aside from the differences in the economic growth and economic development, economists have also looked into the relationship of the terms to see how one affects another. Some economists often use economic growth as a determinant of economic development or economic development as a determinant of economic growth. In the case of the latter, the changes in economic development like technology used in production and better institutions is said to lead to changes in the national income which affects economic growth. On
the other hand, economic growth is said to lead to economic development as the increase in income provides funds that will be used for better educational systems and access to technology.

The idea that economic development is an increase in the quality of resources like education; increase in the quantity of resources; increase in the value of goods and services produced by every sector of the economy while economic growth is an increase in a country's real level of national output which can be caused by an increase in the quality of resources like education; increase in the quantity of resources; increase in the value of goods and services produced by every sector of the economy suggests that economic development is a determinant of economic growth.

Opposed to this notion is Smith (2003), who states that development is not necessarily the same as growth, although in poor countries growth is generally a precondition for meeting important development goals, such as poverty reduction, but if growth is a necessary condition for development in poor countries, it is not a sufficient condition. This is supported by the statement by the World Development report “The challenge of development...is to improve the quality of life. Especially in the world’s poor countries, a better quality of life generally calls for higher incomes, but it involves much more. It encompasses as ends in themselves better education, higher standards of health and nutrition, less poverty, a cleaner environment, more quality of opportunity, greater individual freedom and a richer cultural life”. It implies that a country needs higher incomes to fuel the 'better' quality of life.

Economic growth and Economic development were previously measured with the same indicators but with the recent differentiation in the terms, the measurements indicators differ as well. Dhamija (2008) states that the most recognised indicators used for assessing a nation’s economic growth are Gross Domestic Product, Gross National Product and Balance of Payments. Majority of the literature that measure economic growth use the Gross Domestic Product and Gross National Product as an increase in these terms depict a robust economic growth.

Gross National Product as stated by Dhamija (2008) comprises the total produce of a nation, but it excludes the earnings of foreigners on its land and includes the amount earned by its people in nations other than the own. On the other hand, Gross Domestic Product is defined by Kulkarni (2008) as the total market value of all final goods and services produced in an economy in a given time period. We can defer that Gross Domestic Product is more interested with where the production occurred and is less concerned with who produced it, whereas the reverse works in case of Gross National Product. Gross Domestic Product is also equated to Gross National Product minus the net inflow of incomes from outside the country.

Iyoha (2001) explains that using data on gross domestic product instead of gross national product improves the picture of the economic effect marginally and according to Dhamija (2008), Gross Domestic Product and Gross National Product are efficient indicators but Gross Domestic Product is favoured over Gross National Product as an economic growth indicator because cross-country employment is stepping up gradually; thereby making the former a better estimator than its latter counterpart. However, the indicators of economic growth (GNP and GDP) have certain limitations.
One of which is the fact that the rate of inflation can affect GDP by making growth rates seem larger, it is also affected by population rate, GDP does not measure the impact of economic growth on the environment, GDP only shows what each person would have if GNP were equally divided (does not account for income distribution) and it does not measure individual economic success or hardship.

Economic Development is measured using either the Human Poverty Index, World development Index and Human Development Index. Human Poverty Index is an indicator developed in 1997 by the United Nations Development Programme. The Human Poverty Index sets three factors on which development should be measured as the index depicts poverty as a factor of development. These factors are life expectancy, basic education and economic provisions like health. The Human Poverty Index takes account by measuring the three elements which include Longevity measured by life expectancy at birth, Knowledge which is measured by level of illiteracy in adults and the combined gross primary, secondary and tertiary enrolment ratio and Standard of Living measured by Gross domestic product per capita. The World Bank uses the World Development Index (an annual compilation of data concerning development) in measuring economic development. The Human Development Index is a comparative measure of well-being, life expectancy, literacy rate, child welfare, education, and standards of living of a country. Human Development Index, similar to the Human Poverty Index also measures three aspects of human development which are longevity, knowledge and living standards. The major difference between these measures is the fact that World development index is concerned with the economic aspects of development while Human poverty index and Human development index are more concerned with the human outcomes to emphasize the idea that the individuals and their skills should be the ultimate criteria for evaluating the development of a country.

There are various theories on economic development. These theories explain why development has not occurred in some countries and what can be done to foster it. However, each theory has its strengths and weaknesses. Below are the four main theories of economic development:

- Linear stages growth model
- Structural change theory
- International dependence revolution (dependency theory)
- Neo-classical counterrevolution

Linear stages growth model emphasises the crucial role of savings and investment as it states that the key to development requires the implementation of a program providing for a massive injection of capital coupled with public sector intervention designed to accelerate the pace of economic development. Thirwall (2004) in line with the linear stages model state that growth of output of any economy depends on capital accumulation and that capital accumulation requires investment and an equivalent amount of saving to match it. This theory is supported by Rostow's stages of growth model and the Harrod domar model.

Rostow's stages of growth claim that development results through series of five successive stages all countries must go through. The five stages include traditional society, pre-conditions for take off into self-sustaining growth, the take off, drive to maturity and the age of high mass consumption. the traditional society is characterized by subsistence economy – output not traded or recorded; existence of
barter; high levels of agriculture and labour intensive agriculture. The pre-condition stage is characterized by the development of mining industries; Increase in capital use in agriculture; Necessity of external funding; Some growth in savings and investment. The take off stage is characterized by increasing industrialisation; Further growth in savings and investment; Some regional growth; Number employed in agriculture declines. The drive to maturity stage is characterized by growth becomes self-sustaining – wealth generation enables further investment in value adding industry and development; industry more diversified; Increase in levels of technology utilised. The age of high mass consumption is characterized by high output levels; Mass consumption of consumer durables; High proportion of employment in service sector. According to Rostow, advanced countries have passed the 3rd stage and that less developed countries are in stage 1 and 2. The harrod domar model, based on work by Roy Harrod (1939) and Evsey Domar (1946), shows the link between investment leading to growth. It shows that GDP growth is proportional to the share of investment spending in GDP i.e the growth rate of GDP depends on the level of savings and the capital output ratio.

Criticisms of the Linear stage growth model:
- Too simplistic
- Necessity of a financial infrastructure to channel any saving into investment
- Failure to recognise that capital accumulation is not a sufficient condition for development
- It failed to take into account the crucial fact that contemporary developing nations are part of a highly integrated and complex international system in which even the best and most intelligent development strategies can be nullified by external forces beyond the countries’ control.
- Rostow’s growth model assumed that if savings and investments were injected into developing countries through direct foreign investment or aid, economic growth would naturally follow
- Necessary versus sufficient conditions; savings and investment is necessary for accelerating growth rates but not sufficient
- Harrod domar assumes fixed output-capital ratio over time
- Harrod domar model assumes that aid flows will go into investment 1 for 1. but in many cases, aid flows lead to reduction of domestic savings (White 1992)
- Assumption of zero sustainability between labour and capital
- No role of technical change

Structural change theory focus on mechanism by which developed countries transform their economy from heavy emphasis on subsistence agriculture to more modern, urbanized, industrially diverse manufacturing and service economy. It also implies that development may only be achieved through an internal expansion of the local economy. Two well-known representative examples of the structural-change approach are the “two-sector” theoretical model of W. Arthur Lewis and the “patterns of development” empirical analysis of Hollis B. Chenery and his co-authors.

The Lewis two-sector model primarily focuses on the process of labor transfer and growth of output and employment in the modern sector by emphasizing the importance of attempting to analyse the many linkages between the traditional sector and the modern industry. The two sector model states the 1st sector as the traditional
overpopulated subsistence rural sector with zero marginal labor productivity (allows for surplus labor) and the 2nd sector as the highly-productive modern urban industrial sector into which labor from the rural areas can transition into. Patterns of development approach is an empirical analysis of the sequential process through which the economic, industrial and institutional structure of an under-developed economy is transformed over time to permit new industries to replace traditional agriculture as the engine of economic growth.

Criticisms of structural change theory:
- It assumes that urban wages are constant, allows for perfectly elastic supply of rural labor to modern sector
- Assumes there is surplus labor in traditional sector
- Assumes that all rural workers share equally in the output
- Assumes that modern sector capital stock can increase as a result of reinvestments of profits by industrial capitalists
- Assumption of diminishing returns in modern sector is not held
- Rate of labor transfer and employment creation may not be proportional to rate of modern sector capital accumulation
- Labor is not surplus in rural areas and there is no full employment in urban area
- The model implicitly assumes that the rate of labor transfer and employment creation in the modern sector is proportional to the rate of modern-sector capital accumulation
- Assumes the notion that surplus labor exists in rural areas while there is full employment in the urban areas
- Notion of a competitive modern-sector labor market that guarantees the continued existence of constant real urban wages up to the point where the supply of rural surplus labor is exhausted
- Its assumption of diminishing returns in the modern industrial sector.

International dependence model implies that advanced capitalist countries exploit developing countries and that this could be overcome with the enactment of new policies to eradicate poverty and more diversified employment opportunities. This approach has three major streams of thought which include the neocolonial dependence model, the false-paradigm model and the dualistic-development thesis.

The neoclassical dependence model, an indirect outgrowth of Marxist thinking, attributes the existence and continuance of underdevelopment primarily to the historical evolution of a highly unequal inter-national capitalist system of rich country–poor country relationships. The false paradigm model attributes underdevelopment to faulty and inappropriate advice provided by well-meaning but often uninformed, biased, and ethnocentric international “expert” advisers from developed-country assistance agencies and multinational donor organizations. The dualistic development thesis represents the existence and persistence of increasing divergences between rich and poor nations and rich and poor peoples on various levels.

Criticism of international dependence
- Flawed and unrealistic
- The actual economic experience of LDC's that have pursued revolutionary campaigns of industrial nationalization and state run production has been negative
- They offer an appealing explanation of why many poor countries remain underdeveloped, they offer little formal or informal explanation of how countries initiate and sustain development.
Neoclassical counterrevolution states that economic stagnation in developing countries is a byproduct of poorly designed economic policies and excessive state interference in the economy. It states that in order to stimulate the domestic economy and promote the creation of an efficient market, developing country governments have to eliminate market restrictions and limit government intervention. The neoclassical approach can be divided into three component which include the free-market approach, the public-choice (new political economy) approach, and the market-friendly approach.

The free-market approach states that any government intervention in the economy is distortionary and counterproductive. It also assume that developing-world markets are efficient and that whatever imperfections exist are of little consequence. The public-choice theory, also known as the new political economy approach, goes even further to argue that governments can do nothing right because politicians, bureaucrats, citizens, and states act solely from a self-interested perspective, using their power and the authority of government for their own selfish ends. It concludes that minimal government is the best government. The market-friendly approach recognizes that there are many imperfections in less developed countries and that governments do have a key role to play in facilitating the operation of markets through “nonselective” (market-friendly) interventions. An example would be by investing in physical and social infrastructure, health care facilities, and educational institutions and by providing a suitable climate for private enterprise.

Criticism of neoclassical counterrevolution

- Existence of market failure (externalities, monopoly)
- Problems of equity in allocation - wealth and income distribution

In summary, each of these approaches to understanding development has something to offer. Their respective contributions will become more clear later in the book when we explore in detail both the origins of and possible solutions to a wide range of problems such as poverty, population growth, unemployment, rural development, international trade, and the environment. They also inform contemporary models of development and underdevelopment, to which we turn in the next chapter.

External debt, economic growth and development

Theoretical Review

The Theoretical aspect is concerned with the channels through which external debt can affect economic growth. The effect of external debt on economic growth has largely focused on the debt overhang theory, which predicts a negative relationship between the two variables. Krugman (1988) defines debt overhang as a situation in which the expected repayment on external debt falls short of the contractual value of debt. The debt overhang theory states that debt affects the economic growth through the disincentive effect and illiquidity effect. The debt stock (volume of debt) is concerned with if the country has the assets required to clear this debt in the long run which affects the economic growth through the disincentive aspect of the debt overhang. The debt service burden (flow of debt payments) is a short term problem concerned with how the debt payments can be serviced from the current income and this affects the economic growth through the illiquidity aspect of the debt overhang which is also captured by the crowding out effect in other studies.
The disincentive effects discourages from future investments. This reduces investment spending, leading to a slowdown in economic growth. The cycle continues with further reduction in investment following the economic slowdown, an increase in the debt-income ratio, and a reinforcement of the disincentive effect, which ultimately leads to stagnation (Chowdhury). Due to the compulsions of debt servicing, under which the debtor country shares only partially in any increase in output and exports, high levels of debt are seen as a tax on investment. This discourages any incentives to invest.

Claessens and Diwan (1990) define liquidity trap (illiquidity) as crowding out effects as the indebted country allocates resources to service debt rather than invest in its economy. Debt overhang is considered as liquidity trap on the basis that with a high external debt to service, the indebted country has to struggle with having to allocate scarce financial resources between consumption, investment and external transfer to service existing debt. Therefore, the requirement to service debt reduces funds available for investment and growth. A reduction in the current debt service should, therefore, lead to an increase in current investment for any given level of future indebtedness (Cohen 1993). The illiquidity aspect of debt overhang is stressed by Adu (2004), who reports that the debt service burden has militated against Nigerian’s rapid economic development, worsened the social problems and the service delivery by key institutions designed to mitigate the living conditions of vulnerable groups has been hampered by decaying infrastructure due to poor funding.

Debt overhang also depresses investment and growth by increasing uncertainty. As the size of the public debt increases, there is growing uncertainty about actions and policies that the government will resort to in order to meet its debt servicing obligations, with adverse effects on investment. In particular, as the stock of public sector debt increases, there may be expectations that the government’s debt service obligations will be financed by distortionary measures (the inflation tax, for example), as in Agénor and Montiel (1996). The extensive literature on uncertainty and investment suggests that in these circumstances, potential private investors will prefer instead to exercise their option of waiting (Serven 1997). Moreover, any investment that takes place is likely to be diverted to activities with quick returns rather than to long-term, high-risk, irreversible projects.

**Empirical Review**

Numerous empirical literatures exist on the external debt, economic growth and development nexus. Some studies aim to investigate the debt overhang theory, some provide additional support to the already existing theories and some provide basis to the arguments to the conflicting relationship between external debt, economic growth.

Elbadawi et al (1996) support the debt overhang theory using the analysis of the four variables which he states as channels through which external debt may affect economic growth. The direct channels include the debt inflows as a ratio of GDP, past debt accumulation and debt service ratio. The indirect channel is the impact on public sector expenditures. Were (2001), with the adoption of the model based on Elbadawi et al (1996), investigates the impact of external debt on economic growth in Kenya with the use of certain debt indicators which include debt to GNP ratio, debt to export ratio, debt service ratio and interest to export ratio. The paper also
supports the argument that external debt can affect economic growth through debt overhang. It lists the channels through which debt overhang can indirectly affect economic growth which include the lack of access to international financial markets and the general level of uncertainty. The variables employed in this study are similar to that of Elbadawi et al (1996) with the exception of a newly introduced variable, the net foreign financing as a proportion of the total deficit. The study shows a high and negative correlation between external debt and economic growth, a positive relationship between terms of trade and economic growth and a high and positive relationship between private investment and economic growth.

Karagol (2002) investigates the nexus between external debt and economic growth also by indicating the different channels by which external debt may affect investment and output. These include the debt overhang effect, the high domestic real interest rates and the low profitability due to the downturn in economic activity. The paper uses a standard production function model of Cunningham (1992) to investigate the long-run effects of external debt service on GNP level on time series data from 1956 to 1996. The results show that external debt service will have a negative short-run impact on economic growth in Turkey. It also shows that there is a uni-directional causal relationship between debt service and GNP level. The result as stated in the paper indicates that debt overhang is an important factor for Turkey. It indicates that debt service is a deciding determinant of GNP.

Maghyereh et al (2003) examines the impact of external debt on the economic growth of Jordan to help determine its optimum level by using the endogenous growth models developed by Romer (1986), Lucas (1988) and Pagano (1993) in analysing the time series data from 1970 to 2000. The results indicate that at about 53 percent of GDP is the optimal level of external debt in Jordan which means when the external debt exceeds this level; it starts to have a negative impact on the economy. The results show a strong positive and statistically significant relationship between investment and economic growth. Unlike most studies, it finds a positive and statistically significant relationship between growth and external debt. similarly, Amin and Audu (2006) find a positive relationship between debt and growth when they investigated the impact of external indebtedness on Nigeria’s economic performance from 1970 to 2004 by employing the same model used by Elbadwi (1996) and Were (2001). The results showed that debt servicing pressure in the country has had a significant adverse effect on the growth process but that past debt accumulated relates positively to economic growth which was a much unexpected result.

Patenio and Tan-cruz (2007) aim to establish a relationship between economic growth and external debt service payments of the Philippines from 1981 to 2005. It begins by defining total external debt as debt owed to non-residents repayable in terms of foreign currency, goods or services. It also lists the channels through which the external debt obligations can affect economic performance as debt overhang theory and the crowding out effect. The debt overhang hypothesis is explained as the external debt causing a negative effect on investment which makes it hard for the debtor country to benefit fully from any increase in production since a part of the production goes to creditor countries to pay the debt service. The crowding out effect is explained that a reduction in the debt service should lead to an increase in investment for
any given level of future indebtedness, so if a greater portion of foreign resources are used to service external debt, very little is available for investment and growth.

An analysis of the long-run and short-run relationships between external debt and economic growth is carried out by Hameed et al (2008) on Pakistan from the period 1970 to 2003. This study examines the effect of GDP, debt service, capital stock and labour force on Pakistan’s economic growth using the neoclassical production function inspired by Cunningham (1993). The results of the analysis show that the debt service ratio tends to negatively affect GDP. Generally, the results show the existence of short-run and long-run causal relationship running from debt service to GDP. Hameed et al (2008) argue that the debt servicing burden has a negative impact on the productivity of capital and labor, which in turn adversely affect economic growth. Malik et al (2010) findings are also on the same lines as that of Hameed et al (2008), in its analysis of the external debt and economic growth relationship in Pakistan for 1972 to 2005. Their analysis show that external debt is negatively and significantly related with economic growth which suggests that increase in external debt will lead to decline in economic growth. It also shows that debt servicing has a significant and negative impact on GDP growth, which suggests that as debt servicing tends to increase, there will be fewer opportunities for economic growth.

Ahmed (2010) examines the impacts of the extent of the external debt problem and it’s sustainability on the government’s efforts to reduce poverty, sustain growth and peace in Sudan using a per capita income-growth model (PCI) which is used as a proxy of growth and development in low income countries and has been developed by Clements and others. The results indicate that a huge amount of external debt would reduce the growth rate of per capita income greatly which he states confirms the debt overhang hypothesis in Sudan’s external debt case. Ezebasili et al (2011) also finds a negative impact by investigating the relationship between Nigeria’s external debt and economic growth from 1975 to 2006. They give definite figures that a 1 percent in external debt resulted in a decrease of 0.027 percent in GDP and a 1 percent increase in total debt service resulted to a 0.034 percent decrease in GDP. The empirical results indicate that there is a negative short-run relationship between economic growth and the present level of external debt in Nigeria. There also exists a negative short-run relationship between two lags levels of external debt service payment and economic growth.

Ahmed and Shakur (2011) aim to bring to light the problems created by the external debt to economic growth of Pakistan using the time series data from 1981 to 2008 and arrive at the conclusion that the growth rate of GDP per capita has negative relationship with external debt, population growth and trade openness but a positive relationship with investment. They conclude that their analysis estimates that there is a unilateral relationship between external debt and economic growth, so therefore, external debt is the main economic indicator behind low economic growth even though other macroeconomic variables also affect economic growth. Diallo (2007) uses variables similar to Ahmed and Shakur (2011) in reviewing the impact of debt on economic development; to assess the impact of external indebtedness on Guinea’s economic development for the 1972 to 2005 period, the study drew on the Patillo et al. (2002) model and finds that all the debt ratios are negatively correlated to the per
capita GDP growth rate short or long term. However, owing to its coefficient and significance, the outstanding debt to export ratio is one of the major obstacles to economic development in Guinea as a one-point increase in the debt to export ratio leads to a six-point decrease in growth. The study states that the debt service to export ratio is negatively correlated to the growth ratio which leads to the conclusion that the external debt impacts negatively on per capita growth.

Adam (2004) examines the interaction between external debt and economic growth by analysing Nigeria’s foreign debt to see how sustainable it is. He recognizes the factors associated with the fact that the Nigerian debt is highly unsustainable as high initial debt stock, high interest rate, lower real GDP growth and large trade deficits. He lists that a large external debt can have certain consequences like undermining a long-term development strategy of a nation, imposing a number of constraints on the country’s growth prospect, drains a country’s limited resources, curtails financial resources for domestic developmental needs and depresses investment. This study presents a standard inter-temporal debt model which draws from various authors like Fishlow (1988), Barbosa and Cal (1989), Gunning and Mash (1998) and Rapu (2003) and employs analytical methods which helped him conclude that the effect of external debt on economic growth is negative.

As the studies above find either positive or negative relationships between debt and growth, Adesola (2009) concludes a mixed outcome after reviewing and analysing the effects of external debt service payment practices on the economic growth and development in Nigeria from 1981 to 2004. The variables used in this study include the gross domestic product, the gross fixed capital formation and the annual debt service payments to each creditor. The data was analysed using the ordinary least squares multiple regression method. The results of the tests conclude that there is a significant relationship between gross fixed capital formation at current market prices and external debt services. It also shows that there is a significant relationship between gross domestic product at current market prices and external debt services. The paper concludes a mixed outcome that debt payments to the creditors affect the economic growth both positively and negatively.

However, some studies also find no significant effect. Ogunmuyiwa (2011) examines whether external debt actually promotes economic growth in developing countries using Nigeria as a case study. The results reveal that causality does not exist between external debt and economic growth as causation between external debt and economic growth was found to be weak and insignificant in Nigeria. The results lead to the conclusion that since the causation between external debt and economic growth could not be established in the Nigerian context and therefore external debt could thus not be used to forecast improvement or slowdown in economic growth in Nigeria, neither can it predict changes in gross domestic product with the changes in economic development. This paper explains its results by pointing out that the periods 1985 to 1995 and 2000 to 2004 were periods of high debts /GDP percent but slow or negative GDP growth rates in Nigeria. It states that the situation is not unconnected with wasteful expenditures and high level of financial indiscipline on the part of the Nigerian leaders at this time.
Institutions, Economic growth and development

In understanding the relationship between institutions, economic growth and development, we need to clarify what the term 'institution' means. North (1990) defines institutions as the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction and similar to North (1990), Greif (2006) states that institutions might be defined as a set of social factors, rules, beliefs, values and organizations that jointly motivate regularity in individual and social behaviour. However, institutions have various types ranging from financial, social, political and economic institutions which makes it difficult to find an indicator for the overall aspects of institutions.

Institutions have been examined from effect of it's quality. Institutional quality is concerned with if the institution can achieve it's goal and functions efficiently. Alonso 2004 defines institutional quality with four basic criteria which include:

- Static efficiency: the institution capacity to be incentive-compatible. In other words, it is the capacity to promote behaviours that reduce social costs
- Credibility (or legitimacy): the institution capacity to define inter-temporary credible contracts. That is to say, it is the institution’s ability to generate a normative framework that truly determines agents’ conduct
- Security (or predictability): an institution fulfils its function if it reduces the uncertainty associated with human interaction. In fact, one of the institutional functions is to grant a higher level of safety and stability to social relations by diminishing transaction costs
- Adaptability (or dynamic efficiency): This is to say, institutional ability to be able to anticipate social changes or at least to generate the incentives that facilitate agents’ adjustment to these changes.

Institutional quality can be proxied by governance (Busse et al. 2007), governance in the WGI by Kaufmann, Kraay, and Mastruzzi (2008) is defined as consisting of the traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them. As earlier stated, the study of institutions faces the limited reliability of the available institutional quality indicators (Arndt and Oman, 2006) due to the fact that it's indicators are qualitative judgements based on human and possibly subjective opinions from surveys and risk ratings. The measurement of institution is still in challenging position also because of the fact that it is difficult to measure certain concepts involved in governance like democracy, human rights, government effectiveness and transparency. The other shortcomings of the institutional quality indicator as provided by Alonso (2004) include the fact that the indicators often contain value judgement that are not made explicit; that the indicators do not distinguish between institutions and policies; the quality of data used to build the indicators is unlikely to be homogenous across countries. The lack of appropriate measurement indicators leads to the fact that, we do not have yet a developed body of theory capable of linking polities, institutions, institutional change and economic performance. (Helpman 2004 and North 2005). Chang (2005) reviews some of...
the key theoretical issues involved in developing a good understanding of the relationship between institutions and economic development. These include the definitional issues, the failure to distinguish the forms and the functions of institutions, the excessive focus on property rights institutions, and the failure to build a sophisticated theory of institutional change. With the idea that a satisfying theory of institutions and their economic effects is still non-existent, Chang and Evans (1999) provide case studies of institutions with key roles in shaping economic change. Their main aim is to use these case studies to illustrate theoretical perspective that they would like to develop and they mostly succeed in pushing the thinking of institutions and economic change forward but nevertheless still lacking a theoretical background. However, economists have provided underlying theories by the suggestions of what channels institutions might affect economic performance through and this hypothesis has been further tested empirically by other economists.

North (1990) suggests that the primacy of institutional quality is a fundamental determinant of per capita income levels and growth rates which both matter for long and short-term growth. This hypothesis has been further tested by other economists. Ahmad (2011) using datasets obtained from the International Country Risk Guide (ICRG) and Polity IV, relies on neoclassical growth framework to formalize the channel of institutional effect on growth. The results of this study finds on overall support for the theory that institutions matter for economic growth and that it affects growth through the total factor productivity.

Aron (2000) brings to light specific channels in the production process that is affected by the institutions. He states that the institutional framework affects growth because it is integral to the amount spent on both the costs of transactions and the costs of transformation. Transaction costs, for example, are far higher when property rights or the rule of law are not reliable. In such situations private firms typically operate on a small scale, perhaps illegally in an underground economy, and may rely on bribery and corruption to facilitate operations. Transformation costs, too, can be raised substantially because unenforceable contracts mean using inexpensive technology and operating less efficiently and competitively on a short-term horizon.

Dawson (1998) analyzes the channels through which institutions impact economic growth as the total factor productivity or indirectly through investment. This paper finds that economic freedom has a positive impact on growth through total factor productivity and indirectly through investment by using a human capital augmented version of the Solow (1956) model, which was derived from Mankiw, Romer and Weil (1992). Hall et al (2010) follows Dawson (1998) in augmenting the growth model of Mankiw, Romer, and Weil (1992) to incorporate the quality of country's institutions. They try to investigate the role of institutions in determining economic growth by considering investment in physical and human capital. Results show that institutions are positively linked with the output growth. Dawson (1998) tests the significance of political freedom, civil liberties and economic freedom on growth, but finds the latter as the only robust determinant of growth. De (2010) also finds a positive relationship by performing a comprehensive, empirical analysis of the linkages between governance, institutions, and regional infrastructure. The empirical results indicate that governance and institutions are crucial for regional
infrastructure development as every one point improvement in governance results in a 1 to 1.5 point rise in regional infrastructure.

Chong and Zanforlin (2004) puts institutional variables into a standard growth model to measure institutional quality from two sources, but only the data from the International Country Risk Guide (ICGR) has been used in subsequent studies. In this study, institutional quality was proxied by an average of five variables from ICGR: risk of expropriation; repudiation of contracts by governments; law and order tradition; corruption in government; and quality of bureaucracy. The results of this paper are important as they show that higher institutional quality is associated with higher economic growth in the region. de Gregorio and Lee (2004) produce results similar to the paper by Chong and Zanforlin (2004). In this case the institutional factors were proxied by Government consumption; the Rule of Law; the Inflation rate; Democracy; and Openness. All of these variables seem to have the expected effects on economic growth but their effects on TFP are not measured in this study.

Certain indicators of governance like corruption and democracy are also focused on in determining the effect of governance on economic growth. Alesina et al. (1996) find a negative effect of political instability on growth by demonstrating that institutional quality, as measured by bureaucratic efficiency, absence of corruption, protection of property rights, and the rule of law, is important for growth. Mauro (1995) shows that subjective indexes of corruption are negatively linked with investment and economic growth but finds that corruption affects primarily the volume of investment rather than its efficiency. More specifically, high levels of corruption affect the quantity of investment by increasing the uncertainty and instability in the economic environment. He also finds efficient bureaucracies and rule of law positively influence growth. A number of studies have also found a negative effect of democracy on growth. Barro (1996) finds that once the maintenance of the rule of law, free markets, small government consumption, human capital, and the initial level of real per capita GDP are held constant, the overall effect of democracy on growth is weakly negative. Other studies (Helliwell 1992; Levine and Renelt 1992; Dollar and Kraay 2003) also find the direct effect of democracy on economic growth to be negative but insignificant. On the other hand, Rodrik (1997) finds a positive link between democracy and growth. Empirically, Rodrik (1997) finds evidence
on the significance of institutions to the economic success of the high-performing East Asian economies as he shows an index of subjective institutional indicators is exceptionally well-suited for rank-ordering these countries with respect to their growth performance. His model specification containing only initial income, initial education, and institutional quality accounts for virtually all of the variation in growth performance among these economies even when the quality of institutions is instrumented by using the exogenous determinants. Similarly, Campos and Nugent (1999) show that governance characteristics in the East Asian and Latin American countries are able to explain the economic performance in the regions for period 1972-1995. Specifically they find quality of bureaucracy have played prominent role in improving the development performance in East Asian countries, and rule of law in Latin American countries.

Some studies do not find evidence of institutional effect on the economic performance. Kaufmann and Kraay (2003) find no evidence of a positive effect of incomes on the quality of institutions and Glaeser et al. (2004) show that the evidence that institutions cause economic growth is non-existent. This study explores the causal link between institutions and economic growth and their results do not establish this link. They also suggest that research in institutional economics, and in particular on the consequences of alternative institutional arrangements, must focus on actual rules, rather than on conceptually ambiguous assessments of institutional outcomes.

Khalil et al (2007) confirm that their assumptions on the impact of legal and economic institutions especially, property rights and economic freedom are significantly correct as they find that more than 80% of the variation in GDP per capita in the OECD countries can be explained by both economic and legal determinants. They conclude that countries can develop faster by enforcing strong property rights, fostering an independent judiciary, attacking corruption, dismantling burdensome regulation, allowing press freedom, and protecting political rights and civil liberties.

Unlike other economists, Alonso (2004) focus on a causality aspect of the relationship between institutions and development and the empirical research suggests that the quality of institutions depends essentially on development level, income distribution, tax revenue and education. It also suggests that development fosters good institutions, thus creating a virtuous circle between growth and institutional quality. Good institutions, is defined in this paper as institutions that stimulate agents’ activities with a high social return. Thus, they will draw together private and social returns, assuring a more efficient collective effort allocation.

External Debt Management and Economic Growth.

External debt management includes the debt stock, debt service burden and the institution involved in the debt management process. Various studies support the statement that the external debt management of a country affects its growth process. However, the effect being negative or positive depends on the country in context as it depends on the quality of the institutions in the country. Presbitero (2008) investigates the relationship between external debt and economic growth, focusing on the role played by the policy and institutional framework and the results for a panel of 114 developing countries show that the debt-
growth nexus depends on institutions and policies.

Weak institutions may tend to increase the country’s reliance on crisis-prone forms of financing, thereby increasing the frequency and severity of crises (Ito and Rose 2004). Valev (2006) supports this by stating that the quality of institutions can affect the debt maturity profile and structure of the country, which shows that the quality of institutions also affects the ability of a country to obtain long-term loans from the external markets.

The ability to borrow time-structured loans is not the only issue that affects the country characterized by weak institutions, as the economic growth experienced in these countries is also time structured. Bussière and Fratzscher (2008) have shown that there is a time varying relationship between debt management and growth, with countries with weaker institutions experiencing faster economic growth in the short term, but then experiencing temporary growth reversals in the medium to long term as the unconstrained debt growth causes burdens on the economy. Kutivadze (2011) examines the effect of public debt on growth by controlling for the institutional environment in which the debt was issued in countries grouped by income levels for the period of 1990 to 2007. The findings provide support for the hypothesis that the quality of institutions is a potentially important factor for long-term growth.

An indicator of the quality of institutions, like corruption or democracy may also affect the relationship between external debt and growth. In the case of corruption, a corrupt government is more likely to borrow as they have a higher discount of the future and not utilize the loans. A corrupt government is more likely to use the loan for useless projects instead of projects that yield future revenue. In the case of democracy, a non-democratic government’s decision when borrowing and when to service the debt is unclear. The quality of governance may increase the probability of default in a country (Ciocchini et al., 2003). A democratic government may also borrow for selfish reasons due to the uncertainty of their tenure.

We can infer from past studies that the quality of institutions is very important in the relationship between external debt and economic growth, as it determines if external debt will affect the country negatively or positively. It also determines if the growth of the economy will be short-term or long-term.

Conclusions and Recommendations

This paper concludes that the quality of institutions play an important role in determining the effect of external debt on economic growth in a country as the availability of foreign funds is not sufficient to stimulate the economic growth, there is a need of good governance along with better quality of institutions that will act as a catalyst and improves the efficiency of capital (Agnor and Montiel, 2010).

It is recommended that countries with poor political-economic institutions have to focus on the reformulation of these institutions. The fact that these institutions are majorly dependent on the political institutions makes it difficult. However, to motivate the countries with poor institutions, it is recommended that external debt be issued with measures to improve the institutional quality. This should shift focus to improving their institutions, which will create a better condition and work towards a positive impact of external debt on growth.

References


World development report 1998
World development report: 2000-2001, selected development indicators, economy, 294