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Mitigating the effects of external debt burden in Africa

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ABSTRACT

This dissertation looks at how African countries can mitigate the effects of external debt burden. African countries are enmeshed in unsustainable external debts that have led to debt overhang problems, declining output, escalating current account deficits and worsening human welfare indicators. These external debt burdens are further worsened by the structural weaknesses of these economies. The World Bank and the International Monetary Fund have initiated strategies aimed at trying to arrest the escalating debt burden such as rescheduling, structural adjustment programs and the highly indebted poor countries initiative. However, African countries continue to experience difficulties in servicing external debts. The objective of this study is to find ways by which African countries can effectively manage their debt burden and possibly come up with self pre-qualification schemes that would forestall future external debt problems. The questions the study seeks to answer are: how can African countries effectively manage their current debt burden? What can African countries do to forestall the pervasive external debt accumulation in the future?

To address these questions, I develop a dynamic stochastic general equilibrium model of external debt burden for Africa. The model is estimated using the maximum likelihood method by applying the Kalman filter to the state space representation of the model. Empirical results of the model suggest that African countries need to refine their basket of imports and mainly import inputs that can be used in the production sector as opposed to importing consumption goods. Most importantly, these countries must re-think their export products and markets, and perhaps endeavor to export final goods as opposed to exporting primary commodities.

Furthermore, simulations of the model show that an expansionary monetary shock and a favourable world commodity price shock leads to an increase in external debt. On the other hand, the world interest rate shock leads to a fall in external debt. An interesting result worth highlighting is that a favourable commodity price shock leads to an increase in imported investments but the increase in imported investments does not translate into increased output. On the other hand, an unfavourable world interest rate shock leads to a fall in imported investments. Generally, these findings suggest that African countries are vulnerable to external shocks.

In pursuit of the second objective – possible ways of sourcing external debt and managing it sustainably – I find that the appropriate threshold level for debt sustainability is a ratio of external debt to gross domestic product of between 40%-60% for Africa compared to 120%-150% for Latin America. Surprisingly, East Asia has the lowest significant debt sustainability threshold of the three emerging market regions. On liquidity, which is captured by the short-term debt to reserves ratio, the threshold is 60%-80% for all the three regions. On governance, a stable political environment plays a crucial role in determining the external debt burden of African countries. An improvement in the legal system and a stable political environment leads to an increase in exports and a fall in consumption imports. These in turn reduce foreign debt. These findings suggest that African countries must pursue proper governance practices if they are to appropriately and effectively manage their external debt in ways that enhance economic progress instead of economic retardation.

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