

**Domestic Solvency and External Debt:  
Does the Source of Central Government Debt Matter?**

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The argument set forth in this research primarily examines the relationship between external debt held by multilateral development institutions and central government debt. The results indicate that central government debt holds potential explanatory power to illuminate how the presence of external debt operates indirectly through central government debt. Just as “the source of capital investment matters” (Dixon and Boswell, 1996) the source of central government debt may matter. Various debt instruments – external bilateral development institutions, public and private financial, and non-financial private sector- may vary in their ability to promote a productive return on investment for physical and human capital.

Central government debt is one indicator out of several indicators considered to be factors that comprise the over all solvency of the domestic economy. In order to test the proposed increasing relevance of domestic debt on the social and economic development of a country we utilize two aggregate data sets. For measures of external debt and domestic solvency of a country, we utilized the Global Development Network Growth Database (William Easterly and Mirvat Sewadeh, 2001). The data set contained numerous measures on the structure of the domestic economy including central government debt, domestic investment, external debt, and expenditures on health and general public services for 263

countries for the years 1985 through 1996. For measures of maternal and child health and nutrition we utilized data from the Demographic and Health Surveys data sets for 161 countries for the period 1997 through 2002.

This research expands the scope of the World System and Dependency theories that emphasize the deleterious effects of the extent of external debt held by multilateral institutions (Chase-Dunn, 1975; Pfister, 1984; Harris, 1986; Sell and Kunitz, 1986-87; Meldrum, 1987; Harsch, 1989; Bradshaw and Huang, 1991; Bradshaw et. al, 1993) *and* examines the structure of capital formation in the growth and development of Third World countries (Chase-Dunn 1975; Bornschier, Chase-Dunn, and Rubinson, 1978; Bornschier and Chase-Dunn, 1985; Timberlake and Kentor, 1983; Bradshaw, 1987; Walton and Ragin, 1990; Dixon and Boswell, 1996; Firebaugh, 1996).

The globalization of capital and the emerging global economy has as McMichael (1996: 25-26) notes, "...embedded national economies [and] dissolved the sovereignty of the nation state." The global financial system operates under a logical integrity that maximizes profits for shareholders at the expense of the social welfare of a country's citizens (1996:35-40). A major concern for development economists today is the persistent unresponsiveness of a developing country's economy to intervention programs aimed to improve economic performance and standards of living that promote healthy lifestyles. Easterly (1999:6) observes, "The necessity of waves of debt relief may suggest something is wrong with the implementation of debt relief. There is the paradox that a large group of countries came to be defined as highly indebted at the end of the two decades of debt relief and increased concessional financing." The International Monetary Fund and The World Bank have become increasingly aware of the need to recognize that the debt crisis of less developed countries (LDCs) is fundamentally a problem of solvency and not liquidity of cash reserves. They now concur that the Balance of Payment (BoP) accounting methods and the standard indicators of debt dependency ratios are no longer sufficient in understanding development and dependency issues. Solvency issues of a nation necessitate a higher level of specificity in the monitoring of fiscal and monetary policies, as compared to the Balance of Payments (BoP) approach. This higher level of specificity includes measures of domestic assets, domestic debt, and net present value of both external and domestic debt stock (*External Debt Statistics: Guide for Compilers and Users*, World Bank, 2001).

The debt crisis is more than an issue of liquidity it is also an issue of solvency. The Balance of Payment accounting methods and the standard indicators of debt dependency ratios are no longer sufficient in understanding development and dependency issues. Originally, external debt was assumed to reflect a country's inability to maintain capital flows (liquidity) due to

poor performance of their export commodities. Recently, both the World Bank and the International Monetary Fund's research agenda have considered the increasing importance the overall solvency of a domestic economy that includes not only external debt, but also domestic debt and conversely domestic assets.

A report issued March 21, 2002 by the International Development Association (IDA) and International Monetary Fund stated, "Domestic debt is becoming an important aspect of fiscal sustainability [and] imprudent domestic borrowing could undermine debt sustainability. However, underdeveloped domestic financial markets seriously limit the role of domestic debt in many other heavily indebted poor countries. The best approach to public debt management should cover all categories of debt including domestic debt" (External Debt Management in Heavily Indebted Poor Countries, March 21, 2002:2). Conventional debt management policies have typically been guided by ensuring long-term debt sustainability by reducing the level of outstanding debt and keeping new borrowing in line with payment capacity. There is a growing consensus among multilateral institutions that the present process for restructuring debts is more unpredictable and more damaging to the country and its creditors than would be desirable (Krueger, 2002:1).

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