Debt and Democracy

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Democracies use windfalls from international commodity price booms to reduce external debt. Autocracies tend to spend them

COMMODITY-exporting countries often experience large commodity price shocks that pose serious challenges to their macroeconomic stability. For example, the sudden influx of foreign earnings from a surge in commodity prices can increase a country's real exchange rate (the nominal exchange rate, adjusted for inflation) and make its noncommodity exports less competitive. The effect of such unanticipated price changes on the competitiveness of commodity exporters has been studied widely by economists.

There are other significant, if less studied, repercussions on commodity-exporting countries from such price shocks, which boost both foreign reserves and government revenue. The way the government uses revenue earned from a commodity price surge has a direct effect on a country's macroeconomic performance and can be beneficial or harmful.

When prices boom, the sudden increase in revenue makes it easier for commodity-exporting countries to repay their external debt. But booms end. A wise use of the revenue earned during good times would be to pay down external borrowing to prepare for leaner times. But a country that does not make judicious use of the windfall—or even uses the boom to accumulate more debt—may find itself in more difficulty. That is because debt would become a bigger portion of its diminished post-boom financial resources and would be harder to pay. The situation is compounded if, as is often the case, the debt is denominated in a foreign currency, such as U.S. dollars. If a windfall received during a commodity price boom is not used to reduce external debt, an external debt default (loosely defined here to include debt restructuring, even if there is no formal default) may follow. Some researchers argue that the 1970s commodity price booms spawned excessive external debt in a number of commodity-exporting countries—for example, Venezuela and Nigeria—which led to the debt crises of the 1980s (Deaton, 1996; Krueger, 1987; Sachs, 1989a).

The prevailing view in international finance literature is that high levels of external debt undermine economic performance by effectively acting as a tax on future investment projects and constraining the financing of these projects (Krugman, 1988; Sachs, 1989b). Given large swings in commodity prices in recent years and the 2009 debt crisis in Dubai, policymakers must gain an understanding of the link between the external debt of commodity-exporting countries and movements in international commodity prices. We investigated that link by studying 93 countries during 1970–2007 and concluded that there was a significant difference between the way democracies and autocracies handled the boom. We focused on government behavior regarding gross external debt as is common in the literature. It is important to remember, however, that some countries have also accumulated financial assets such as international reserves that reduce their overall net position with the rest of the world.

What windfalls bring

In democratic countries (see Box 1), where political institutions hold political leaders to some degree of accountability, positive commodity price shocks are associated with significantly less external debt and risk of default on that debt. In countries with deep autocratic regimes, where political leaders have little or no public accountability, windfalls from international commodity price booms were not used systematically to reduce external debt; moreover, the risk of default on external debt significantly increased in these countries after revenue windfalls from commodity price booms ceased.

Why? Because these regimes used a large part of those windfalls on government consumption. Increases in government consumption expenditures are not necessarily harmful. Indeed, from the standpoint of social welfare, if a windfall is used to provide public goods such as education and health services in an efficient manner, the spending can be beneficial.

But in autocracies, the increases in government consumption expenditures were mostly unproductive, largely benefiting powerful elites. In oil-exporting countries, for example, fuel products were often subsidized, resulting in large fiscal costs and overconsumption, which disproportionately helped the rich, who consume much more energy than the poor (see "Reducing the Staggering Costs of Cheap Energy" in this issue of *F&D*). Because spending in what have been called countries with "grabber-friendly political institutions" squanders public funds and crowds out production activity (Mehlum, Moene, and Torvik, 2006), per capita gross domestic product (GDP)—a common, if incomplete, measure of social welfare—does not increase during commodity price booms.

In democracies, on the other hand, we did not find a large and significant increase in government consumption expenditures during commodity price booms. The revenue windfalls led to a significant increase in per capita GDP.

We also found that in democracies, international commodity price booms were often accompanied by a significant improvement in the rule of law (see Box 2). Increases in the international prices of exported commodities may raise the return on domestic investment, especially in the resource sector, but if investors fear expropriation by the government of a significant portion of their profits, private investment may not increase significantly despite a higher return on domestic capital. Many democracies responded to investors' fears by providing assurance to potential investors that their property rights would be respected. In many autocracies, by contrast, the rule of law was already weak and did not improve—or even deteriorated—during international commodity price boom windfalls.

What is there to learn?

More conservative administration of windfalls in countries with more democratic institutions yields a clear benefit: reduction of external debt. And that means a lower tax burden on future investment projects. So most citizens prefer policies that reduce external debt, especially if there is a serious risk that the government will squander revenue windfalls from international commodity price booms on low-return projects. Democratically elected political leaders, because they are accountable to the public, appear more willing than their autocratic counterparts to promote (or accede to) external debt reduction.

History repeats

As a result of international financial deregulation in the 1990s and the associated capital flows from industrial to developing economies, many countries suffered excessive indebtedness, which led to the 1990s debt overhang (existing debt high enough to deter investment). Multilateral and bilateral creditors provided systematic debt relief for the poorest economies. Among those benefiting were several low-income but commodity-rich countries. But when commodity prices began to boom again after 2000, some of those commodity-rich countries, especially in sub-Saharan Africa,

Box 1

Democracy or autocracy

We divided the 93 countries in our study into democracies and autocracies, based on the criteria set in the Polity IV database (Marshall and Jaggers, 2009). The classification uses a 10-point scale that categorizes four attributes of political systems: the competitiveness of political participation, the competitiveness of executive recruitment, the openness of executive recruitment, and the constraints on the chief executive.

At one end of the scale, +10, are the most politically competitive and open democracies. At the other, –10, are the least open and competitive autocracies. We considered a country to be autocratic if the average score over the period 1970–2007 was below zero, and deeply autocratic if it was below –6. Democratic countries had a score above zero, and those that were strongly democratic registered above +6. Of the 93 countries, 52 were autocratic, 13 deeply so, and 41 were democratic, 14 of them strongly democratic.

Box 2

Rule of law

There are two aspects to the rule of law (International Country Risk Guide, 2009). The law component captures the strength and impartiality of the legal system. The rule of law also encompasses the notion of "order," that is, how well the laws are followed. A country can have a highly rated judicial system but an overall low rating if it has a very high crime rate or if its citizens routinely ignore laws with impunity.

began to borrow heavily—from China and other new creditors. This new borrowing raises questions about the sustainability of commodity-rich countries' public finances and the possibility of a new vicious cycle of excessive indebtedness and another debt overhang.

To limit those risks, commodity-rich countries with poor records of fiscal discipline—especially autocracies—should consider implementing government budget rules at the outset of a commodity price boom. Fiscal rules are numerical targets on budget aggregates—such as the structural deficit (the difference between government spending and revenue, adjusted for the state of the business cycle), expenditures, and debt. In theory, fiscal rules make sense because they aim to prevent commodity-rich countries from borrowing excessively. In practice, fiscal rules are not always effective. Indeed, creative accounting, political pressure, and the abuse of public office for private purposes can affect a government's commitment to the implementation of fiscal rules. This is especially true in the arbitrary world of autocracies. Difficulties with the implementation of fiscal rules include the design of an appropriate system of checks and balances and of a public communication strategy. These difficulties signal a need for more research and debate over policy design in environments with poor governance. ■

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