MANAGEMENT OF EXTERNAL DEBT IN INDIA

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The external debt of a country is considered to be properly managed if it is under sustainable limits. The Indian economy since 1991 has displayed episodes of imbalances in its debt position, capital flows and external sector. This paper discusses the perspectives of India's external debt management in the light of the external debt policy measures adopted by government of India since 1991. It also analyses the external debt sustainability position of India during the period from 1991-92 to 2012-13. The approaches used to examine India's external debt management include (i) Review of Policy Environment that accounts to policy changes done by Indian Planners, and (ii) Sustainability Assessment of External Debt on the basis of Debt Indicators proposed by IMF, World Bank, and also by Martin Feldstein.

Key words: External Debt Management, Debt Crisis, Debt Sustainability

INTRODUCTION

The balance of payment crisis in India that was initiated in 1985 became severe by the end of 1990. The size of external debt reached US$ 83 billion by March 1991, of which 45 percent was contracted from private creditors at variable interest rates. By end of 1990, the government was close to default, the RBI refused new credit, and the foreign exchange reserves reduced to such a point that India could barely finance three weeks' imports. Accordingly, India had to airlift its gold reserves to pledge with International Monetary Fund (IMF) for external debt.

To overcome all this fiscal and balance of payment (BoP) crisis the Government of India on 23rd July 1991 launched process of economic reforms, where the Extended Fund Facility (EFF) of International Monetary Fund (IMF) was provided to mitigate the crisis given. This support put some obligatory conditionalities and led to emergence of so called LPG policy based on Rao-Manmohan Model. It also raised the elevation of India's

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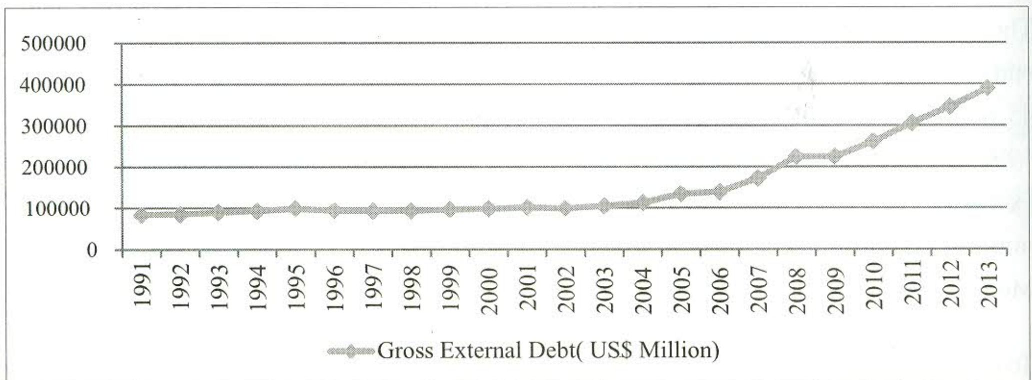
external debt from US$ 83,801 million in 1991 to US$ 3, 05,861 million by the end of FY 2011 indicating a drastic increase in external debt in post liberalization era[1]. The external debt stock of India at the end of year 2013 stood at US$ 3, 90,048 million, recording an increase of US$ 44,550 billion (12.89 per cent) over the level of US$ 3, 45,498 million at end-March 2012. Figure 1 displays the mounting of external debt accumulation since 1991.

The economic theory behind external debt accumulation states that reasonable levels of external debt by a developing country are likely to enhance its economic growth, but beyond certain levels additional indebtedness reduces growth. Countries at early stages of economic development have small stocks of capital and are likely to have investment opportunities with rates of return higher than those in advanced economies. As long as they use the borrowed funds for productive investment, they do not suffer from macroeconomic instability. Hence, countries borrowing from abroad must keep in mind debt management aspects as major policy concern. Inappropriate and excessive foreign borrowing generates debt service obligations which may constraint future policy along with growth.

Figure 1: India's Gross External Debt (US$ Million)



Source: Statistical Database, Reserve Bank of India (www.rbi.org)

Borrowings allow a country to invest and consume beyond the limits of current domestic production and, in effect, finance capital formation not only by mobilizing domestic savings but also by tapping savings from capital surplus countries. Foreign borrowings particularly can lead to more rapid Growth. However, if a country borrows from abroad, it must also introduce debt management as a major policy concern. Inappropriate and excessive foreign borrowing generates debt service obligations, which constrains future policy and hence the economic growth.

MANAGEMENT OF EXTERNAL DEBT: THE GENESIS

External debt management refers to effective control of the level of the debt, its composition, and its terms and conditions in order to keep it within the desired limits and obtaining the best available terms of it. Since debt financing involves repayment obligations, the debtor country must undergo severe strains which may limit the future economic policy of the country. Thus, the external debt management is an integral part of balance of payments and macroeconomic management, it has direct interface with macroeconomic variables, such as, exchange rate, general price level, production, aggregate demand, cyclical changes, excessive leveraging, and thereafter deleveraging etc. impinge on borrowing requirements, capacity to borrow and debt servicing capabilities and could have long lasting effect on economy.

The Report of World Bank and International Monetary Fund (IMF) on External debt Sustainability (2001) stated that a country can be said to achieve external debt sustainability if it can meet its current and future external debt service obligations in full, without recourse to debt rescheduling or the accumulation of arrears and without compromising growth. To this end the report prescribed that it can be attained "by bringing the net present value (NPV) of external public debt down to about 150 percent of a country's exports or 250 percent of a country's revenues". [2]

The objective of debt management policy is to achieve the benefits of external finance without creating difficult problems of macroeconomic and balance of payments stability. The external debt management broadly consists of two aspects, (i) external debt sustainability, and (ii) the policy environment.

This paper is divided into six sections, viz., (i) Introduction (ii) The Genesis of External Debt Management, (iii) Review of Policy Environment that accounts to policy changes done by Indian Planners, (iv) Evaluation of India's External Debt Indicators, (v) Sustainability Assessment of India's External Debt based on Debt Indicators proposed by IMF, World Bank, and Martin Feldstein, and (vi) Conclusion.

EXTERNAL DEBT MANAGEMENT IN INDIA: A POLICY PERSPECTIVE

India experienced a near balance of payments crisis in 1991. One of the causes

[2] Report of World Bank and IMF (2001), "The Challenge of Maintaining Long Term External Debt Sustainability", Volume 1, P-6

contributing to the crisis was the rapid growth in external indebtedness and the consequent deterioration in key external debt indicators. India was however, able to avoid a debt crisis and never defaulted on its debt obligations. The analysis of policy measures attempted in this section aim at drawing out various policy measures concerned with external debt which have taken place since 1991. The whole idea is to point out what were the key policy aspects which led India towards lower indebtedness since 1991.

The key policy areas in context of India's external debt management are: (i) External Commercial Borrowings Policy, (ii) Short-term Debt Management, (iii) Non-Resident Deposits (iv) Prepayment of High Cost Debt.

External Commercial Borrowings (ECB) Policy: External commercial borrowings are the commercial loans taken from non-resident lenders for a minimum maturity period of 3 years. ECBs can be raised from internationally recognized sources such as (i) International Banks, International Capital Markets, Multilateral Financial Institutions (such as IFC, ADB etc.), (ii) Export Credit Agencies, and (iii) Suppliers of Equipment, Foreign Collaborators and Foreign Equity Holders[3]. ECBs can be raised via (i) Automatic Route, and (ii) Approval Route. The Indian planners looked ECB'S as additional source to finance its development expenditure but in cautionary manner. These are used to finance development expenditure in various projects of PSUs, promotion of export sector, and other development projects. The use of ECB's in capital market, real estate is prohibited to avoid any kind of speculations.

Short Term Debt Management: The policy regarding short-term debt is focused on liquidity problems and maturity structure of short term external debt. India's short term external debt management policy focuses on:

- Restricting the quantum of the short-term debt to manageable limits,
- A minimum maturity of one year for foreign currency denominated non-resident deposits,
- Allowing short-term debt transactions only for import purposes, and
- Discouraging roll-over of short-term liabilities beyond six-months.

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[3] Ibid, P-34

India's short-term external debt policy is largely based on the lessons taken from balance of payments crisis of 1991. One of the crucial factors that led to balance of payments crisis in 1991 was the relatively high level of short-term debt, which stood at US$ 8.5 billion at end-March 1991, and the rollover difficulties associated with the short-term liability. The whole idea behind short-term debt management policy of India is to restrict the short term debt to avoid payment crises in future.

Non-Resident Deposits: The policies regarding non-resident deposits are aimed at providing stability to such capital flows through various measures taken by Indian planners. Some important features of policies regarding non-resident deposits are[4]:

- Promotion of non-repatriable deposits.
- Rationalization of interest rates on rupee denominated deposits.
- Linking of interest rates to LIBOR for foreign currency denominated deposit.
- De-emphasizing short-term deposits (of up to 12 months' duration) in case of foreign currency denominated deposits.
- An active use of reserve requirements in relation to the cycle of capital flows that has been employed as a part of monetary management.
- Elimination of foreign exchange risk to the official agencies. Exchange guarantees provided by RBI on such deposits were also discontinued.

Prepayment of High Cost of Debt:

The crux of the whole problem of long term external debt is concerned with low capital formation and mounting burden of non-remunerative debt (of which terms & conditions are unfavorable and interest rates are high). Indian planners have always tried to retire such non-remunerative debt. Further, to boost capital formation and enhance forex reserves, Indian planners, in the past, introduced some innovative products like, India Millennium Deposits (IMDs). The Objective of the scheme was to provide an investment opportunity for NRIs in long-term fixed income instruments. The tenure of IMDs was five years denominated in US dollar, Pound, Sterling and Euro, with the option of cumulating or non-cumulating interest. Government's guarantee, inter-alia, covered Government's commitment to bear foreign exchange risk beyond one percent per annum on a cumulative basis on the total pool of foreign currency deposits raised

[4] Ibid, P-37

through the scheme and also tax benefits to the deposit holders. The strategy of retiring high cost debt and introduction of innovative deposit schemes is a positive sign of asset-liability management. All this helped India in building up credit worthiness and restoring the confidence of investors.

In nutshell, India's external debt management policy always propelled upon concessional/ less expensive debt with larger maturity profiles. It amicably monitored short-term debt flows, retired high cost of debt before due dates, and encouraged non-debt flows, such as foreign direct investments (FDI) and deposit schemes for foreign nationals and NRIs.

INDIA'S EXTERNAL DEBT INDICATORS

The level of external debt, along with its key indicators, is measured and monitored on a regular basis. Some of the important sustainability and liquidity indicators, such as, external debt-to-GDP, short-term debt-to-GDP, share of short-term debt in total debt, debt service ratio and short-term debt-to-forex reserves, are monitored more frequently. Debt sustainability is assessed on the basis of indicators of the debt stock or debt service relative to various measures of repayment capacity (typically GDP, exports, or government revenues). The basic equation of external debt indicator is as follows[5].

$$\text{Debt Indicator} = \frac{\text{Indebtness}}{\text{Repayment Capacity}}$$

Countries use several measures to identify solvency and liquidity risks associated with external indebtedness. Liquidity problems arise when a country has difficulties in meeting its short term financial obligations as they come due. Solvency problems, on the other hand, arise when a country's repayment difficulties are permanent or protracted. Delineating liquidity and solvency risks can be a challenge because liquidity problems can turn into solvency problems if not adequately addressed. Table 1.1 shows liquidity and solvency position of India's external debt since 1991-92.

[5] External Debt Sustainability Analysis, (2012), Special Issues, IMF

Table 1: India's External Debt Indicators

Year	Debt Service Ratio	Forex Reserve to Debt	External Debt to GDP	Concessional Debt to Total Debt	Short Term Debt to Total Debt
1991-92	35.3	7.0	28.7	45.9	10.2
1992-93	30.2	10.8	38.7	44.8	8.3
1993-94	27.5	10.9	37.5	44.5	7.0
1994-95	25.4	20.8	33.8	44.4	3.9
1995-96	25.9	25.4	30.8	45.3	4.3
1996-97	26.2	23.1	27.0	44.7	5.4
1997-98	23.0	28.3	24.6	42.2	7.2
1998-99	19.5	31.4	24.3	39.5	5.4
1999-00	18.7	33.5	23.6	38.5	4.4
2000-01	17.1	38.7	22.0	38.9	4.0
2001-02	16.6	41.7	22.5	35.4	3.6
2002-03	13.7	54.7	21.1	35.9	2.8
2003-04	16.0	72.5	20.3	36.8	4.5
2004-05	16.1	101.2	17.8	36.1	4.0
2005-06	5.9	106.4	18.5	30.9	13.3
2006-07	10.1	109.8	16.8	28.6	14.1
2007-08	4.7	115.6	17.5	23.0	16.3
2008-09	4.8	138.0	18.0	19.7	20.4
2009-10	4.4	112.1	20.3	18.7	19.3
2010-11	5.8	106.8	18.3	16.8	20.0
2011-12	6.0	85.2	19.7	13.9	22.6
2012-13	5.9	74.9	21.2	11.7	24.8

Source: External Debt Status Reports (Various Issues)

Debt Service Payments or debt servicing or debt service ratio refers to the set of payments, inclusive of both principal and interest, actually made to meet debt obligation. It portrays the liquidity position of a country, and is measured by the proportion of gross debt service payments to external current receipts, excluding receipts on account of official transfers. India's debt service ratio has shown a declining trend since 1991-92 when it was as high as 35.3 per cent. The ratio of foreign exchange reserves to total external debt reflects the availability of resources with which the external debt can be serviced. The cover of external debt in terms of India's forex reserves (including foreign currency assets with RBI, gold, SDRs and Reserve Tranche

in IMF) has shown steady uptrend since 1990-91. The external debt-to-GDP ratio is defined as the ratio of the total outstanding external debt (at the end of the year) to annual GDP. By using GDP as a denominator the ratio provides some indication of country's potential to service external debt by switching resources from production of domestic goods to the production of exports. It is noteworthy that a country might have a large debt-to-exports ratio but a low debt-to-GDP ratio if exports of the country comprise a very small proportion of GDP. Table 1 shows that India's external debt to GDP ratio has been declined since 1990-91.

The concessional component of a loan refers to its softer terms and conditions as compared to the prevailing market conditions. Concessionality of a loan is reflected in lower interest rates, extended grace period, longer maturity period or combination of all. To measure the concessionality of a loan, the difference between the face value of loan and sum of the discounted future debt service payments to be made by the borrower is calculated. In India, loans from International Development Association (IDA), International Fund for Agricultural Development (IFAD), Organization of Petroleum Exporting Countries (OPEC), Government borrowings from bilateral sources (except dollar denominated debt from Russia), and Rupee debt are included in concessional debt. The ratio of concessional debt to total external debt of India has been declined continuously since 1990-91. The short-term debt generally includes all types of trade related credits up to one year, FII investment in treasury bills, and other short-term debt instruments having a maturity of one year or less. Table 1 shows that the proportion of short term debt in country's total debt has increased in last few years. This is mainly due to improvement in the coverage of short-term debt.

INDIA'S EXTERNAL DEBT MANAGEMENT: SUSTAINABILITY PERSPECTIVE

External debt Sustainability refers to "the level of debt which allows a debtor country to meet its current and future debt service obligations in full, without recourse to further debt relief or rescheduling, avoiding accumulation of arrears, while allowing an acceptable level of economic growth"[6]. Over time there have been several indicators and thresholds used internationally to assess the debt sustainability of low income countries.

[6] Report of World Bank and IMF (2001), "The Challenge of Maintaining Long Term External Debt Sustainability", Volume 1, P-6

Prior to HIPC initiative in 1996, the debt sustainability was assessed by using ratios of debt stock to GNP and/ or exports, and debt service to exports. Even today we don't have internationally agreed benchmarks for determining external debt sustainability. However, among several measures, the widely accepted approaches include debt sustainability assessment indicators proposed by IMF, World Bank and the Martin Feldstein's approach of sustainability.

The World Bank regularly publicizes the range to classify countries as severely/ moderately/ less indebted. This approach uses three-year average of the ratio of Present Value (PV) of debt to GNP or Present Value (PV) of debt to exports of goods and services. Present Value (PV) of debt, which is aggregate of PVs of all loans, is calculated by discounting future streams of debt service payments for individual loans at appropriate discount rates. The Indebtness benchmarks proposed by IMF also indicate the external debt position of country based on PV of GNI and PV of exports of goods and services. The description of benchmarks used to measure external debt sustainability level is shown in table 2.

Table 2: Indebtness Benchmarks

Either		Severe
PV/XGS >220	PV/GNP >80	
Either		Moderate
132<PV/XGS<220	48< PV/GNP<80	
Both		Less
PV/XGS132	PV/GNP<48	

Source: External Debt Status Report (2001), Ministry of Finance

Martin Feldstein considers external debt to GDP ratio as a prime indicator of debt sustainability. According to Martin Feldstein's approach the ratio of external debt to GDP should not be allowed to increase. A country should recognize that it is in trouble if it finds its ratio of debt to GDP rising year after year. In other words, Government revenues must exceed non-interest outlays of the government. The excess of revenue must be sufficient to finance the interest payments on the public debt to avoid a rising ratio of debt to GDP. A budget deficit implies that the national debt is increasing. If GDP of a country rises, the ratio of the national debt to GDP may or may not increase. This depends on whether the growth rate of the national debt is more than or less than the growth rate of GDP. A continually increasing ratio of debt to GDP runs the risk of the debt going towards an unsustainable path leading to national insolvency. Even if it does

not turn unsustainable, a high ratio of debt to GDP has serious adverse consequences on the economy of a country.

Table 3: India's External Indebtedness Indicators

Year	PV/GNP Ratio	PV/XGS Ratio	Indebtness classification	Year	PV/GNP Ratio	PV/XGS Ratio	Indebtness classification
1993-94	26	214	Moderate	2003-04	18	95	Less
1994-95	25	191	Moderate	2004-05	16	73	Less
1995-96	22	152	Moderate	2005-06	15	53	Less
1996-97	21	151	Moderate	2006-07	20	82	Less
1997-98	20	147	Moderate	2007-08	18	70	Less
1998-99	18	114	Less	2008-09	17	71	Less
1999-00	16	105	Less	2009-10	18	69	Less
2000-01	15	91	Less	2010-11	18	79	Less
2001-02	17	103	Less	2011-12	NA	NA	NA
2002-03	19	106	Less	2012-13	NA	NA	NA

Source: External Debt Status Reports (Various Issues)

Table 3 shows India's external debt sustainability based on External Indebtedness Indicators. The ratio of PV of India's external debt to GNP and also the PV of debt to exports of goods and services indicate that the state of affairs of India's external debt from 1993-94 to 1997-98 was moderate, and since 1997-98 India is one among less indebted countries. Thus, India's external debt can be considered under manageable limits.

CONCLUSION

The problem of balance of payment crisis initiated in 1985 in India became severe by the end of 1990. To cope with this problem, the Government of India largely relied on Extended Fund Facility (EFF) of IMF. This resulted in accumulation of external debt, higher Debt Service Ratio, and low Forex Reserve to External Debt ratio. Accumulated, Inappropriate and excessive foreign borrowings generate debt service obligations and perhaps constraint future policy along with growth. The government of India has been following prudent external debt management policies by adopting raising funds under government borrowing on concessional terms, and from less expensive sources with longer maturities; monitoring of short-term debt; prepaying high-cost loans as and when considered appropriate; rationalizing interest rates on NRI deposits; restricting end-use of ECB; and encouraging non-debt creating capital flows. The external indebtedness indicators also show that India's external debt is under manageable limits. Though, India holds fourth position among developing countries, its gross external debt at end March

2013 was all time high (US$ 3, 90,048 million). Mounting external debt and interest thereon is a burden on country's GDP. If India's GDP will decline (as estimated by international credit agencies: IMF and ADB in 2013), it may create situation of turmoil. So, Indian planners and policy makers should consider the matter seriously and take necessary steps timely to avoid chaos in the market.

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