UNIT 201 – UPSC - External Debt Management

External capital is significant in India's development process. External debt is defined as the total debt a country owes to foreign creditors. The debtors can be the government, corporations or citizens of that nation. The debt includes money owed to private commercial banks, other governments, or international monetary institutions such as the International Monetary Fund (IMF) and World Bank. External debt as a device to support economic development had been noticeable topics of discussion among economists.

Neoclassical economists debated that external debt is one of the important sources of capital for a country; therefore it has positive impact on investment and the economic progress. Several economists challenged this view and considered external debt as one of the factors obstructing economic growth. They gave explanation that there are numerous problems associated with external debt such as problem of debt accumulation, debt sustainability, and inability of a country to meet debt obligations, inability of a country to raise foreign loans in its own currency. When country's external debt is denominated in foreign currency, the real exchange rate depreciates, the purchasing power of domestic output reduces over foreign claims, and it makes more problematic for a country to service its debt. Knowing that shocks affecting the real exchange rate can disturb country's ability to service its debt, foreign lenders may be less willing to lend.

If a country is incapable to borrow in its own currency, mismatches, debt intolerance (mismanagement of debt), capital flight may rise. The main determinants of this problem) are level of development, financial credibility, fiscal solvency, credit market imperfections, poor contract enforcement, exchange rate regime, political economy arguments, and some other international causes. The incapability of developing countries to borrow overseas exists due to feeble macroeconomic environment that normally persists in developing countries.

Indicators of External Debt Sustainability

There are various indicators to assess a sustainable level of external debt. While each has its own advantage and peculiarity to deal with particular situations, there is no common opinion amongst economists as to one sole indicator. These indicators are mainly in the nature of ratios i.e. comparison between two heads and the relation thereon and thus facilitate the policy makers in their external debt management exercise.
These indicators can be considered as measures of the country's solvency in that they contemplate the stock of debt at certain time in relation to the country's ability to create resources to repay the outstanding balance.
Examples of debt burden indicators are as follows:

1. Debt to GDP ratio,
2. Foreign debt to exports ratio,
3. Government debt to current fiscal revenue ratio.
4. Share of foreign debt,
5. Short-term debt,
6. Concessional debt in the total debt stock.

A second set of indicators mainly concentrates on the short-term liquidity requirements of the nation with respect to its debt service obligations. These indicators are not only valuable early-warning signs of debt service problems, but also highpoint the impact of the inter-temporal trade-offs arising from past borrowing decisions. The final indicators are more forward looking as they emphasize how the debt burden will change over time, given the current stock of data and average interest rate. The dynamic ratios demonstrate how the debt burden ratios would change in the absence of repayments or new disbursements, representing the constancy of the debt burden. An example of a dynamic ratio is the ratio of the average interest rate on outstanding debt to the growth rate of nominal GDP.

Major issue in economic policy is to advance the living standards of the population, which can be accomplished through advancement of investment and speedy economic growth. To promote investment, a country must have enough resources. Otherwise, it will have to borrow from other countries. This is indeed one of the limitations faced by most developing countries. They do not have enough resources therefore, they have to acquire external debt as a channel to shoot economic growth. Additionally, when a country operates a current account deficit on its balance of payments, then to finance the deficit, it may borrow from external sources apart from encouraging foreign investments. It is normal for developing countries to run current account deficit which leads to external borrowings. In case of India, it has been borrowing both from internal and external sources since Independence to finance its investment programme. Gross external debt, at any given time, is the outstanding amount of those actual current, and not contingent, liabilities that require payment(s) of principal and/ or interest by the debtor at some point(s) in the future and that are owed to non -residents by residents of an economy.

The origins of India's External Debt

India remained unpretentious by the debt crisis in the beginning of 1980s facing many developing countries, due to her insignificant level of private debt. The foreign exchange restraints in the repercussion of second oil shock could be relieved by drawing substantial amount of loans from

the International Monetary Fund: SDR 266 million under Compensatory Financing Facility (CFF) in 1980, SDR 529.01 million under Trust Fund Loan (TFL) in 1980-81 and SDR 5 billion under Extended Fund Facility (EFF) during 1981-84 (of which India used only SDR 3.9 billion). The foreign exchange situation also improved radically due to the inflow of payments from the Gulf. Reports indicated that India's external debt record stood at $440.6 billion at end of March' 2014 recording an increase of $31.2 Billion over the level at end March 2013. The maturity profile of India's external debt indicates dominance of long term borrowing. The rise of external debt during the period was due to long term debt particular NRI deposits. A sharp increase in NRI deposits reflected the impact of fresh foreign currency non-resident, deposits mobilized under the swap scheme during September November' 2013 (New Media Wing, 2015).

The external debt policy followed by India emphasizes monitoring of long term and short term debt, raising sovereign loan on concessional term with longer maturities, regulating external commercial borrowing through end use, all in cost and maturity restrictions and rationalizing interest rates on Non-resident Indian deposits. Consequently, external debt has remained with in manageable limits (New Media Wing, 2015).

A considerable amount of import savings could be made due to large-scale import substitution in the areas of food, petroleum (after the discovery of Bombay High) and fertilizer. Thus, an improved foreign exchange situation, which along with the available multilateral concessional assistance helped India to maintain her credit-worthiness and avoid a possible liquidity crunch of the Latin American type in early 1980s. In fact taking the advantage of the improved foreign exchange scenario, Indian policy makers tried to relax the severity of the controlled trade regime in the 80s.

The liberalization of the import control regime, particularly the category of Open General License (OGL) and export-related licenses, offered numerous imports that were required by a range of emerging consumer goods industries. Export growth remained slow in the decade of eighties, due to the slowdown in the growth of world trade, weakening in primary commodity prices in the global market, and the expansionary policy at home, as the later might have reduced the exportable surplus to some extent. Definitely the trade deficits went up from $ 5.9 billion in 1984-85 to $ 7.9 billion in 1990-91 (with $ 9.1 billion in 1988-89) and the current account deficits from $ 2.4 billion to $ 8.9 billion during the same period (based on RBI data). With the near stability in the inflows of concessional support, financing of deficits were made by raising commercial loans from the Eurocurrency markets in the form of syndicated loans and Eurobonds as well as accepting short term foreign currency deposits from the non-resident Indians.

It can be established that external debt means debt owed by a country to foreign governments or foreign nationals or international institutions. The economic basis for debt creation is that borrowers can earn a higher economic return than the cost of invested funds and that these economic returns can then be translated into financial returns. There is heated debate on the determinants of the demand for foreign borrowing by developing countries. The determinants of external indebtness of a country can generally be categorized into four categories such as poverty driven indebtedness (the savings gap), the foreign exchange gap, the return argument, and the contribution of external factors.

External debt does not spontaneously transform into debt burden when funds are optimally utilized. In best condition, the marginal return on investment is greater than or equal to the cost of borrowing. According to Edelman (1983), the critical factors affecting debt service capacity are

returns on investment, the cost of borrowing, and the rate of savings. The benefits of external borrowing have been emphasized in the literature to the neglect of the costs. Ubok-Udom (1978), computes the costs of external borrowing to include debt service burden which incorporates costs implied by the term structure of external loans, costs of resultant liquidity crisis, costs of the viciously cumulative debt, the manageability of the debt, costs of debt rescheduling, and costs of import substitution among others. According to Colaco (1985), debt service vulnerability in developing countries using three contexts. First, the size of external loans has reached a level that is much larger than equity finance, resulting in an imbalance between debt and equity. Secondly, the proportion of debt at floating interest rates has risen dramatically, so borrowers are hit directly when interest rates rise. Thirdly, maturities have shortened considerably in large, part because of the declining share of official flows.

To summarize, External debt is one of the sources of supporting capital formation in any economy. Debt management is the establishment of the conditions for the issue and redemption of public securities. It involves the process of administering the national debt that is, providing for the payment of interest and arranging the reinforcing of maturity bond. Once a debt is raised, it becomes contractually obligatory for the payment of their interests and capital as at when due. The way these debts are managed have a lot of implications for government revenue and expenditure as the debt and their interest would have to be repaid from current government revenue or through issuance of new debt instruments.