External Debt and Economic Reform by Dr. Y.V. Reddy, Deputy Governor, Reserve Bank of India, Seminar on New Opportunities in Global Finance sponsored by Greater Mysore Chamber of Industry Bangalore Management Association Institute of Internal Auditors - India Rotary Club of Bangalore

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Mr. Chairman and Friends,

I am thankful to the organisers of this conference and Mr. Biswas of the Reserve Bank of India (RBI), for giving me this opportunity to be with you. For some of you, external debt is a matter of business concern, but for many in our country, it evokes emotive response. Today, I will give a brief review of our external debt policy since independence - especially how we got into the external payment crisis in 1991, and how we got out of it. We will recapitulate important changes in policy since then - to show how we have been moving forward. The focus of my address would be popular concerns expressed about our external debt in order to present what I would describe as a true picture of our external debt. Conservative Approach

2. India, after independence, opted for a model of development characterised by what was then perceived as self-reliance. This meant, that until the `eighties; (a) financing of investments almost wholly through domestic savings and recourse to foreign flows at the margin only; (b) reluctance to permit foreign investments or private commercial flows in general; (c) almost total reliance on official, especially multilateral flows, mainly on concessional terms; (d) recourse to IMF facilities to meet extraordinary situations such as the drought in 1960s, oil shock of late 1970s and more recently, in the early 1990s, the Gulf crisis; and (e) relatively greater emphasis on import-substitution rather than export-promotion. In brief, till 1980s, external financing was confined to external assistance, mostly on concessional terms and to or through Government.

Beginning of Commercial Debt

3. In 1980s, global developments, particularly perceptible decline in the availability of official flows in relation to the external financing needs of developing countries (especially under concessional terms), at a time when India initiated liberalisation (through what was described as `New Economic Policy') changed the external sector situation. The compulsions of repayments to IMF during late 1980s added to the problems. Hence, recourse to external debt on commercial terms became inevitable. In addition to institutional sources (such as Export-Import agencies), syndicated loans and bonds, and deposits from non-resident Indians were accessed, often at very attractive terms. These had to be supplemented, in late 1980s with larger than ever before recourse to short term credit facilities though at very reasonable rates of interest. The justification for this approach was to sustain the momentum in growth rate of Indian economy which jumped

from around 3 per cent per annum during 1950-80 to over 5 per cent in 1980s and to maintain the impressive export performance of late 1980s.

Drying up of Commercial Sources

4. The onset of 1990s, however, saw the impact of Gulf crisis on India. Combined with the large fiscal deficits of the `eighties and political uncertainties, repercussions of this development in the Gulf resulted in drying up of commercial sources of financing, withdrawal of non-resident deposits, and what in the face of large depletion in reserves and significant short-term debt overhang, could be described as liquidity crisis in the balance of payments (BoP). Another global dimension that affected India's management of balance of payments during this period was the serious disruption of trade with the erstwhile USSR on top of worrisome recessionary tendencies in the industrialised countries.

   The broad features of the external debt situation on the eve of the Gulf Crisis can be summarised as follows:

   a. In terms of magnitudes, the stock of external debt has grown by more than three times in the 1980s. While our external debt grew by about US $ 2.8 billion per annum during 1980-81 to 1985-86, in the next five years it rose by an average of US $ 6.2 billion per annum. However, viewed as a percentage of GDP, it was still at a modest level of 30 per cent as on March 31, 1991.
   b. The share of debt from commercial sources increased from around 15 per cent in 1981 to around 40 per cent in 1991. The share of short-term debt in total external debt rose from about 4 per cent at the end of 1988 to 7 per cent at the end of 1990-91 - still not very high in terms of size, but unmanageable in the face of a liquidity crisis in the (BoP).
   c. The bulk of the short-term debt has been contracted by public sector canalising agencies for financing the import of petroleum, petroleum products and fertilisers.
   d. Most of the long-term commercial debt and almost the entire official debt has been contracted by the public sector mostly for investment in the core and infrastructure sectors. Financial institutions borrowed in foreign currency to lend to the private sector. There were instances when financial institutions and some public enterprises were required to borrow to provide BoP support though they did not need foreign currency to finance any internal transaction.
   e. External debt servicing as a proportion of current receipts increased from 10.2 per cent in 1980-81 to 35.3 per cent of current receipts in 1990-91. The interest burden, which adds to current account deficit increased significantly in 1980s because of increase in the commercial borrowings component in debt.
   f. The deposits from NRI sources which were US $ 1.0 billion in 1980 increased to US $ 12.4 billion by 1990.
   g. The inherently vulnerable payments position was put under additional pressure during the Gulf crisis in August 1990 through increased import burden, reduced remittances and disrupted exports. This was accompanied by credit downgradings and constriction of commercial credits for Indian borrowers during 1990-91. There were large scale withdrawals from NRI deposits. Disruption of trade with the USSR in 1991 added to the strain on the external balance.

      There was thus, a payment crisis that brought to the fore many pitfalls in managing our economy, especially the inherent risks of reliance on commercial debt as a major instrument of financing current account deficits.

Honouring Debt Obligations

6. There was a realisation - in a sense a national consensus - that liquidity problems in external payments should be overcome through effective changes in economic policies and that management of external debt be reviewed. Of-course, there were some differences regarding the details and the pace of such changes. In the light of a serious threat to India's capacity to honour its debt obligations in 1990-91, after due deliberations, a conscious decision was taken that both default on payment obligations and rescheduling of debt should be avoided. Let me summarise how these approaches and processes were implemented.
    a. Severe restrictions on imports of raw material and components were imposed - described often as `draconian'. But these import compression measures were mainly through banking channels and hence, essentially non-discretionary but reversible and the wheels of `real economy' continued to be oiled by non-reduction in imports of petroleum products and fertilisers. The import of capital goods was permitted only if there was no immediate drawal on currency reserves i.e., through use of credits/loans only. All these restrictions were removed in 1992.
    b. The gold available with Government and the RBI were utilised to raise resources in the short-term to meet payment obligations. Total gold thus used, has since been retrieved.
    c. Multilateral assistance particularly from the IMF and some bilateral support provided us the necessary comfort.
    d. Select commercial banks, that had confidence in India's determination to honour its obligations, could be persuaded to maintain credit lines; though a large segment of bankers and credit-rating agencies (who took recourse to a series of downgradings) had shown negative response.
    e. Some efforts were made to seek cooperation from other developing countries for assistance but in the absence of pre-established mechanisms, these efforts did not yield results.
    f. In regard to processes, monthly, weekly and daily estimates of inflows and outflows of foreign exchange were monitored to enable timely sourcing. Close coordination, between Ministry of Finance and the RBI, was maintained.
    g. All payment obligations were promptly honoured since no priorities were considered in discharging the debt and other contracted obligations as between creditors.
7. In brief, India emerged as a stronger nation, willing to discharge all its external obligations; bear the entire burden of adjustment on its own and initiate appropriate reform measures. But, as a nation we should not forget the lessons of this experience; and for those of us who had to conduct these operations, it has been a traumatic experience.

Reform and External Debt Policy

8. As mentioned, one lesson from the Gulf crisis, apart from the need to contain current account deficit to sustainable levels, was to avoid excessive reliance on commercial debt - especially of short-term maturity to finance current account deficits. These lessons and the policy recommendations are recorded in the report of the High Level Committee on Balance of Payments (1992 and 1993) of which Dr. Rangarajan was Chairman and I had the privilege to be its Member-Secretary. Briefly stated, the advice of the Report, which formed the basis for our reforms in this area was:
    a. Keep current account deficit within sustainable limits. In other words, self reliance is redefined. Earlier, it meant exporting exportable surplus, importing only the gap between domestic supply and demand and, minimising trade/current account deficit. The new approach to self reliance meant addressing both export and import liberally in an internationally competitive atmosphere while ensuring sustainable level of current account deficit and external balance positions;

b. Liberalise current account but keep effective control over capital flows during medium-term;
c. Encourage non-debt creating flows;
d. Have a conscious limit on the total external commercial borrowings and subject them to specific approvals;
e. Review the non-resident deposit policy and discourage volatile flows;
f. Obtain data, monitor and specifically limit the extent of short-term trade related credits, i.e., beyond 180 days and up to one year, and subject them to specific approvals;
g. Cease using public enterprises and financial institutions as conduits to bring in commercial flows to ease pressure on balance of payments; and

(h) Move towards greater clarity and transparency in regard to relevant data.

Clarity and Transparency

9. The issue of clarity is really an issue of defining properly, categories or components of external debt, collecting data in an internationally comparable form and of effective monitoring. Of-course, the issue of transparency relates to clearly explaining the status of external debt. These issues were remitted, at the initiative of Mr. S. Venkitaramanan, the then Governor, RBI, to a two member Policy Group, Mr. Seshan from the RBI and humble self from the Ministry of Finance. The recommendations of the Group (1992) were also accepted and implemented. Without going into technical details, let me summarise the general thrust of the Report relevant to our discussion today.
    1. Common definitions, even at international level, relating to external debt were accepted only in 1988. It is necessary to have a framework of our own, adopted to our needs.
    2. External debt can be distinguished between public or Government, semi-government and private account; between short-term below one year and long-term over one year, whether deposits or trade related; between commercial and non-commercial or concessional usually called external assistance.
    3. Such external debt should be reckoned in terms of currency of liability and should at least be exhibited in both local and some common foreign currency though ideally it should be specific currency-wise.
    4. External debt statistics should be constantly updated and made public periodically.
    5. Institutional and methodological improvements in debt-monitoring and management should be undertaken on a continuing basis.
10. I humbly submit that, today, compared to anytime before, there is greater transparency. We have a periodical public report on total external debt and its components. Debt on account of defence and our rupee debt due to erstwhile USSR is also clearly brought out now in the data. We also have a well laid out policy of external commercial borrowings. Procedures are announced clearly. Above all, the general thrust of the policy has been towards lesser dependence on debt flows compared to non-debt flows, and keeping debt under check. Yet, there are many misconceptions - especially that we, in the RBI are building our foreign currency reserves by increasing foreign debt. I will devote the rest of my presentation to these concerns.

Is External Debt Too Large?

11. There is a perception in some quarters that India has a large external debt. True, India is the sixth largest among all developing debtor nations in terms of the absolute size of the debt. But, the size of the external debt of a country needs to be assessed in relation to the country's economic size (i.e., GDP) and its capacity to service the debt (i.e., current receipts in the balance of payments). As per the conventional four indicators of

creditworthiness (debt/GNP, debt/current receipts; debt-service/current receipts; interest payments/current receipts) or even using the two new indicators suggested by the World Bank based on Present Value of debt, India is classified as a "moderately indebted" country. In terms of these new indicators, heavily indebted countries are those for which the present value of debt to GNP is above 80 per cent or the present value of future debt service to exports (of goods and services, including income and transfers) ratio exceeds 220 per cent. For any country, if the above two indicators are in the range of 48-80 per cent and 132-220 per cent, respectively, then it is classified as moderately indebted. For India, even while the present value of debt to GNP ratio remained significantly lower at 25 per cent during the three year period 1993-95, it failed to qualify as a less indebted country because of its high present value of debt to exports ratio at 191 per cent. In brief, it is not that our external debt by itself is large, but our exports are too small. We should focus on a sustained high growth of exports for joining the group of less indebted economies.

12. Let us compare the size of our debt in terms of various conventional indicators between 1991-92 and 1996-97. The ratio of debt to GDP which was 41.0 per cent in 1991-92, has been declining since then and in 1996-97 it was 25.9 per cent. As a percentage of current receipts, debt was 312.3 per cent in 1991-92 and was down to 163.5 per cent in 1996-97. Let us look at servicing of debt. Debt-service to current receipts-ratio was also down from 30.2 per cent to 25.4 per cent, and interest payments to current receipts has come down from 13.0 per cent to 8.5 per cent during the same period.
13. Simply put, total stock of our external debt was $ 85,285 million in 1991-92, increased to $ 99,008 million in 1995 and by 1996-97 fell to $ 90,852 million; the decline during 1995-97 partly reflecting valuation factors. More important, this time around, we discharged most of our large repayment obligations; a huge liability of about $ 2.2 billion under India Development Bonds, as also FCNR(A) liabilities and IMF repurchase obligations and charges, without correspondingly increasing our external debt. Outstanding balances under FCNRA declined from US $ 10.6 billion as at the end of March 1993 to US $ 721 million by September 1997. Outstanding liabilities to the IMF also declined from a high of US $ 5,040 million to US $ 946 million by September 1997.

Is Credit Rating Low and Cost of Borrowing High?

14. Sovereign or corporate credit rating is done by some international agencies to give an indication of creditworthiness to the investors. We have not made any sovereign bonds issue and our sovereign rating is derived from corporate ratings - especially public sector. We have been at the margin - at low investment grade or high non-investment grade. However, investors make their own assessment before investing in our debt instruments. Empirical evidence clearly shows that our corporates by and large are able to obtain better credit rating by the Agencies. For example, average spreads on international bond issues by Indian corporates at 190 points in 1995 and 267 points in 1996 were finer compared to average of 350 points in 1995 and 334 points in 1996 for all developing countries. Thus, our credit rating in many of the actual debt-deals appears better than what formal ratings indicate. It is reasonable to surmise that our impeccable record in honouring payments and our prudent approach to commercial borrowings, also contribute to this perception.

Did the Government Borrow Excessively?

15. I had explained that, till mid 1980s, most of the external debt was not on commercial terms and has been through external assistance. Recourse to external finance by the Government continues in the form of external assistance, both bilateral and multilateral. Hence, external debt on Government account is less costly than non-Government debt. Also, as a proportion of total debt of government, external debt is a small part by

international standards, or even compared to the past, in our country. Thus, at the end of March 1997, total external liabilities of the Central Government at Rs.53,620 crore represented only about 8 per cent of total liabilities of the Central Government signifying that a very small proportion of the financing of the gross fiscal deficit has been made through external assistance. External assistance inflows are mostly linked to various development oriented projects and hence such borrowings can be presumed to be growth augmenting in nature. The Central Government also, now passes on 100 per cent of the assistance to the States. Also, since a policy of disintermediation was adopted by the Government of India, external assistance for commercial activities and to enterprises, is permitted to flow directly and not through Government Budget. In view of the continued importance of external assistance as one of the three major financing items in the BoP up to the Seventh Plan period (and almost as the single most important source of external financing till the Fifth Plan) Government debt as a percentage of total external debt has however, remained high. In the `nineties, it declined from about 60 per cent in 1990 to about 54 per cent in 1997. In absolute terms, gross external assistance has remained in the range of $ 3 billion to $ 4 billion since 1990-91. As a proportion of total external financing, it declined from 19.2 per cent in 1990-91 to 10.0 per cent in 1996-97.

Has There Been Too Much of Short-term Debt?

16. The size of short-term debt as percentage of total debt has remained low. Compared with the share of short-term debt in other developing countries, India has a considerably low dependence on external financing of short-term maturity. The short-term as a percentage of total debt was 9.9 per cent in 1990 for India as compared with developing countries' average of 17.6 per cent and by 1995 the figure came down to 4.3 per cent for India as compared with 18.3 per cent for developing countries as a whole, the year in which the latest comparable data are available.
17. Our reserve management strategy does take into consideration the size of short-term debt while deciding the adequacy of foreign exchange reserves. At the end of March 1997, the ratio of short-term debt to the level of reserves stood at a little over 25 per cent. The ratio of short-term debt to reserves for Mexico at 220 per cent, for Indonesia at 150 per cent, for Argentina at 64 per cent, for Thailand at 50 per cent and for Malaysia at 30 per cent as at the end of 1995 signify our favourable position in terms of facing any external imbalance situation arising on account of the short-term debt liabilities.

Is the Debt-servicing Burden High?

18. Debt-servicing is essentially a function of the size and maturity pattern of debt stock and the effective rate of interest, while the capacity to service the debt depends on the size of current receipts. In India, the proportion of concessional debt has always been high and despite increasing recourse to non-concessional debt flows in the form of commercial borrowings and non-resident deposits since the early `eighties, the share of concessional debt continues to be of the order of 45 per cent during the `nineties. External debt servicing rose from US $ 1.6 billion in 1980-81 to US $ 14.1 billion in 1996-97, reflecting the increase in the size of debt stock alongside considerable hardening of interest rates of new commitments. During the same period, however, external current receipts which indicate the capacity to service debt increased from US $ 15.6 billion to US $ 55.6 billion. Particularly during the six year period 1990-91 to 1996-97, as against an average increase of 10 per cent in debt servicing, total current receipts exhibited an average growth of about 20 per cent and as a result debt-service ratio came down from 35.3 per cent in 1990-91 to 25.4 per cent in 1996-97. In the India-specific situation, the present ratio of current receipts to GDP of about 15 per cent could well sustain a current account deficit of about 2 per cent of GDP without posing any debt servicing problem and even

enabling a decline in the debt-service ratio from the present level of 25 per cent if the compositional shift in the capital flows experienced in the recent years continues.

19. Yet another important aspect, when we compare our debt-servicing ratios with other countries is the fact that in many other developing countries, external current payment obligations in terms of dividends is far higher than that of our country. Of-course, as foreign investments increase, we will also have higher dividend payment obligations.

External Debt and Reserves

20. During 1980-81 to 1990-91, when external debt stock rose significantly from US $ 23.5 billion to US $ 83.8 billion, India's foreign exchange reserves declined from US $ 7.4 billion to US $ 5.8 billion. On the contrary, during 1991-92 to 1996-97, when the foreign exchange reserves increased from US $ 5.8 billion to US $ 26.4 billion, the stock of external debt increased at a moderate rate from US $ 85.3 billion to US $ 90.9 billion. It may be observed that during the four-year period (1993-97), against large accretion to the foreign exchange reserves of the order US $ 16.6 billion, the corresponding addition to the debt stock was only US $ 0.8 billion. In the 1990s, however, due to policy induced restructuring of the capital account, non-debt creating flows took place on an increasing scale as a result of which India's external debt stock showed only a marginal rise.
21. It is sometimes argued that we should not increase our borrowings when there is a build up of forex reserves, since the return on reserves is less than the cost of debt. But, it must be noted that, the level of reserves satisfies the need for liquidity, offers insulation against unforeseen shocks and acts as a source of comfort to foreign investors. The cost at which ECB is raised has country and other credit risk built into it, which is influenced by a host of factors, including the level of reserves. The essence of reserves management being safety and liquidity, all the investments made thereof are of top-most credit quality and excellent liquidity and are usually short-term. Hence, the return on reserves and cost of borrowing are not strictly comparable. Reserves, by themselves, should not, therefore, influence the desirable level of external borrowing. In fact, a comfortable level of reserves could help finer spreads in the external commercial borrowings, and in that sense they are complementary rather than substitutable.
22. It is also sometimes argued that we should use our external reserves for lending to the commercial sector for export oriented purposes. This is not a desirable suggestion as once such a loan is extended, foreign currency is not readily available as a foreign currency asset and hence, ceases to have the characteristics of foreign exchange reserves.

Debt Flows out of Total Capital Flows

23. I had mentioned that our strategy was to increase the proportion of non-debt flows in our total capital flows. The debt flows were an average of around 97 per cent for the period up to 1991-92, but the proportion has declined, every year since then and is currently around half.

Maturity Profile of Debt

24. As we noted before, India's short-term debt (less than 1 year of maturity) have remained less than 10 per cent of total debt. Maturity structure of new commitments to India indicate that for official loans, the average maturity has fallen from about 40 years in 1980 to 24 years in 1995 and for private commercial loans, the decline has been from about 15 years in 1990 to 8 years in 1995. Compared with other debtor developing economies, the term structure of the debt flows to India has also been by and large longer. For example, average maturity of new commitments to Mexico was 9 years for official credit and 7 years for private credit.

Government Control over ECBs

25. If a precise statement on our policy towards external commercial borrowings is to made, it would read as follows:

    "Consistent with the overriding norms of prudent debt management, the Government's policy approach towards commercial borrowing essentially reflects the finance needs of the country in terms of sustainable current account deficit and availability and relative costs of various forms of external capital. Prescribing annual ceilings for commercial borrowings and attaching priority in approvals to sectors such as infrastructure (power, telecommunication, transportation, railways, etc.) capital goods imports, and exports have constituted the basic approach towards policies relating to ECBs. Requiring prior authorisation for foreign borrowing is a prudent way of protecting a country's long-term balance of payments position".

    With the impressive improvement in the balance of payments position (CAD/GDP averaging at about 1 per cent during the six year period 1991-97) and a significant shift in the composition of capital inflows in favour of non-debt creating flows contributing to the improvement on the external debt front, our policy towards ECB has been considerably liberalised in the recent past.

26. During the ongoing process of financial sector reforms, with the objective of progressively reducing the interest rate differentials between investible funds raised from the domestic and external markets, ceiling on ECBs have gradually been raised, restrictions on end-use of funds raised through ECBs have been done away with (excluding investment in Indian stock market and real estate), approval procedures relating to maturity and size of borrowings have been made more transparent, and borrowings for maturities greater than 10 years, kept outside the ceiling. FIIs (100 per cent dedicated debt funds) have also been permitted to invest in debt related instruments, both Government and private, within the overall ceiling. With further integration of the domestic financial market with the global financial system, the distinction between domestic and foreign borrowings in terms of cost of capital would be narrowed down.

Critical Issue

27. A critical issue in the matter of external debt is the productive use of debt creating flows. During a control-regime, direct link between external debt and its end-use may be of some relevance, but resources are fungible. As the economy gets liberalised, the total productivity increases in an economy becomes the most critical issue in determining sustainable level of external debt financing, though the actual flows may be on account of cross border transactions among market participants. When capital account is liberalised, global savings could flow to areas where there are perceived high returns consistent with risks. In such a situation also, productivity would remain critical for ensuring external debt sustainability.

True Picture

28. With the detail given so far, we should be able to capture a true picture of our external debt. What is it?

    First, India can be classified as a "moderately indebted country". In fact, it is not that the size of the external debt by itself is large, but our exports are too small. If we improve our exports, we can easily qualify as a "less indebted country".

Second, in the recent past, the extent of indebtedness is actually coming down in terms of the ratio of external debt to GDP and also the ratio of debt servicing to current receipts.

Third, we have been able to achieve these improvements after discharging bulk liabilities under India Development Bonds and IMF.

Fourth, the cost at which the Indian corporates are in a position to raise funds abroad is usually more advantageous than what the formal credit rating by credit rating agencies suggest.

Fifth, the external debt as a proportion of total debt of Government account is very small. The cost at which the Government obtains the external assistance is less than the non-Government external debt. The utilisation by Government is intimately linked to development projects. By virtue of the past policies, Government's debt is still about half of the total external debt. However, as a proportion of total external financing, the Government debt is coming down and currently it is just about 10 per cent.

Sixth, the size of short-term debt as percentage of total debt has been brought down and is low compared with the developing countries' average.

Seventh, the ratio of short-term debt to the level of reserves is very low compared to most developing countries.

Eighth, apart from the fact that our debt service ratio to current receipts is low as compared to many countries, currently our payment obligations in terms of dividends are also far lower than many other developing countries.

Ninth, while in 1980s the external debt rose significantly, the foreign exchange reserves declined. In 1990s, the external debt increased marginally, but the foreign exchange reserves increased by very much more than the external debt, showing clearly that it is not true to say that the reserves have been built with external debt.

Tenth, the proportion of debt flows in the total capital flows has come down from about 97 per cent five years back, to half, i.e., 50 per cent. The maturity structure of new commitments to India has been coming down, but it is still more favourable compared to many other developing countries.

Eleventh, the Government keeps a tight control over the external commercial borrowings. However, gradually there has been easing of restrictions on external commercial borrowings.

Finally, it would be true to say that we have followed a prudent system in regard to contracting external debt and such a prudent policy has been in national interest. Liberalisation of the debt flows is being undertaken on a gradual basis which adds strength to the external payment situation.

Thank you.