1.1. Introduction:

In conventional development theories it is highlighted that the liberalization of the financial sector promotes financial deepening by encouraging savings in financial assets leading to an increase in the volume of credit inflow into the economy. It is further pointed out that capital inflow is an advantage to any developing country. It is said that a needy economy, with its inward looking policies, urgently requires external capital for its growth, while speedy growth requires a steady inflow of capital from both traditional and alternative sources of external finance. Further more, it is argued that there is a need for a free flow of long term foreign capital to enhance both the physical and social infrastructure in the newly industrialized economies. However, this understanding requires a re-thinking in the context of the havoc that external credit has played in many developing countries, in terms of the high cost attached to it, plunging the economies into endless indebtedness. External capital can be compared to the gifted Trojan horse for it has all the potential to defeat the very purpose for which this attractive gift was enthusiastically received into the economy. The basic questions that need to be addressed are the following: (a) What is the cost of external finance? and (b) who benefits from the external capital - the borrower or the lender? It is entirely a different issue if the capital inflow is in the form of transfer of technology or management skills, which tends to achieve faster growth than a volatile or temporary flow of hot money which has a reversible character of capital flight.
This chapter, first, exposes the options of domestic and external borrowings in section 1.2, and traces the historical developments in external borrowings in section 1.3. After briefly raising the issue of the trend in India's external borrowings, in section 1.4, it situates the problem of external borrowings from the background of the Indian economy in section 1.5. The rationale of the study is spelt out in section 1.6. Section 1.7. details the reasons for a comparative study of the Indian economy with that of Mexico. The reasons for the inclusion of some of the major developing economies are explained in section 1.8. Section 1.9. deals with the objectives, hypotheses and the methodology of the study. The Data Sources, and Time Period of study are explained in section 1.10. The layout of the chapters of the thesis is discussed in section 1.11, and section 1.12. Concludes this chapter.

1.2. Domestic Borrowing vis-a-vis the External Borrowing:
1.2.1. A country, for its various expenditure needs, looks for resources from both within the country as well as from abroad through the use of various policy measures. Although raising taxes to meet various government expenditures would be the ideal solution, it is not always politically feasible as political compulsions force the politicians to read the mood of the electorate. At the same time, since most of the public sector units in India have proved to be a burden on the state, moderate tax rates will not be sufficient to meet the expenditure needs of the government. Consequently, India sought to borrow rather than to tax. Theoretically, as Apte (1993) points out, domestic borrowing is a better option over external borrowing, since it implies a transfer of resources from private individuals to government, and remains within the same country. However, excessive domestic borrowing raises a number of problems:
1. 2. 2. Problems resulting from Excessive Domestic Borrowing

Excessive domestic borrowing by the government for its various development and non-development activities leads to the following problems:

1. 2. 2. 1. Although politically an unwise option, an increase in the tax rate would be the best solution to service old debts. However, if the government indulges in more of domestic borrowing to service its old debts, it only postpones and augments the tax burden to a future date. In order to service the debt, the government will have to increase taxes, some time or the other. If tax rates are raised in the future, they will adversely affect the future aggregate supply in terms of curtailed investment, employment and output, and tax evasion. Therefore, domestic borrowing to service old debts only postpones the tax burden, and hence it is not a prized solution.

1. 2. 2. 2. Resorting to more and more domestic borrowing, by raising taxes, and without paying due attention to the burden in terms of interest rates, encourages politicians to imprudent public spending. Taxes will have to be raised in the future to service these debts, but by then these politicians will not be at the helm of affairs.

1. 2. 2. 3. Interest payment on domestic borrowing represents a transfer of funds from the taxpayers' to the government's bond holders. In India, as these bond holders belong mostly to the upper income group, this will exacerbate the inequalities in income distribution. It should be noted that in the past, government's debt instruments were held by government owned financial institutions. As a result, the low interest rates paid on government debt eroded the earning capacity of these institutions, hurting those who had deposited their savings with them.
1.2.2.4. More domestic borrowing by the government from its citizens implies that fewer funds are available to the private sector. This is the so-called "crowding out" effect. This calls for an investigation into the relative rate of return on public and private investments. However, government's expenditure on various welfare measures cannot be captured exclusively by the financial rate of return. Even then, the poor performance of public sector enterprises in India, today, affords reasons to believe that crowding out the scarce capital in the Indian economy is no longer tenable.

1.2.2.5. Theoretically, an increase in domestic borrowing may lead to inflation in two ways: (a) For a bond holder, government debt represents an asset; and for a bond holder the feeling of increased wealth may induce more current consumption than current income thus boosting the demand pressure leading to inflation, (b) Government bonds are a highly liquid form of wealth. In an inflationary situation, the presence of a large number of such bonds will increase the purchasing power thus further stimulating inflation.

1.2.2.6. The norms of demand and supply are applicable to interest and credit. When the government begins to borrow from its domestic sources, it exerts a pressure on the demand for the available funds leading to an increase in the interest rate. Besides, a large amount of domestic borrowing restricts the freedom of the monetary authorities in their use of interest rates as an instrument, since they cannot ignore the impact of higher rates of interest on the exchequer.
However, it should be noted that large domestic borrowing becomes a burden only when it is used to finance current expenditures or unproductive investment, as it crowds out more efficient private investment, and adds to aggregate demand.

1. 3. Historical Developments in External Borrowing:
External financial assistance originated in the disruption of the world economy that followed World War II. Postwar reconstruction was greatly facilitated by the willingness of the United States to finance its large surplus of exports over imports on highly concessional terms under the European Recovery Programme, generally known as the Marshall Plan. Since then, the Organization for European Economic Cooperation (OEEC) which was set up to administer the Marshall Plan, formulated modalities that have been used in administering external assistance. As Western Europe recovered and its former colonies became independent, the OEEC was transformed into an organization for coordinating the bilateral aid programmes and trade policies of its member countries.

At the same time, the International Bank for Reconstruction and Development, which eventually became the World Bank, shifted its loans to developing countries. This shift was accelerated by the establishment of the International Development Association (IDA) as an affiliate of the World Bank. This was followed by the creation of regional development banks for Latin America, Asia and Africa. By the early 1960s, the present institutional framework for
government transfers of resources to less developed countries was largely in place. (see Chenery and Strout, 1956).

From the time of the Marshall plan, the general concepts of international aid and the effectiveness of specific approaches have been the subject of controversy. The neoclassical critique objects to the implied interference with market forces and the possibility that aid may perpetuate inefficient policies (see Johnson 1967).

In macroeconomic terms, external assistance performs two functions: it adds to the resources available for investment and it augments the supply of foreign exchange to finance imports. Although additional aid serves both these purposes, their relative importance varies with the economic structure of the recipient country. Since many of the goods such as machinery, fuels, raw materials etc. that are critical to development must be imported, a shortage of foreign exchange can become a bottleneck when the cost of imports increases more rapidly than export earnings.

The two major assistance programmes designed for this purpose are Project Lending and Programme lending. The magnitude of the Project lending is related to the import of capital goods and other inputs to carry out the project, and that of the Programme Lending is designed to support the recipient country's macroeconomic policies and help in its structural change. However, most donors use aid as a means of supporting national producers by limiting eligible goods procured with aid funds. The economic distortion in the aid system is the common practice of lying procurement to the donor country. Hence the Commission on International Development appointed by the World
Bank recommended that the share of aid channeled through international institutions be substantially increased from its level of ten percent in order to secure more equitable use of available funds (Pearson Commission Report, 1969 provides a comprehensive detail).

By 1970, the system of international aid was criticised for being excessively oriented toward growth, and not paying sufficient attention to the distribution of its benefits (Faber and Seers, 1972). The instability of the world economy following the oil crisis of 1973 has had a large impact on the design and performance of the international aid system. The worsening situation in terms of trade of oil-importing developing countries in 1973-74, and again in 1979-80, involved larger transfers than the total of concessional aid, and they had to be financed mainly by borrowing on commercial terms. The poorest countries, especially the African countries, whose debt servicing capacity is limited, had to restrict their imports to fit the volume of aid available, leading to the reduction of economic growth.

External finance is a manifestation of external resource mobilization through borrowing and is thus a temporary means of bridging the resource gap of the developing countries. However, instead of enhancing the growth rates and repayment capacity of a country, external borrowings led to a virtual cessation of growth with far reaching implications for the recipient countries. For many Sub-Saharan African countries, their past borrowing has imposed a debt service burden that now stands in the way of economic and social progress. It is not primarily a crisis of debts owed to private banks abroad but the debts owed to official agencies, both government and multilateral financial agencies,
as well as to private banks that pose problems. A durable solution to the debt problem requires not just a rescheduling of debt service obligations but a decisive reduction in the total debt stock of the affected countries. Some techniques such as the discounting of the face value of debts to reflect market values have also a place in the search for solutions.

Allowing arrears to continuously accumulate is hardly a solution to the debt problems these countries face. At best it provides only a brief respite. Piecemeal rescheduling and extending finance to facilitate the servicing of interest on debt owed to the creditors are expedients of partial value. They do not serve the primary need of the debtor countries in the present situation, which is the immediate reduction of the total stock of their debts. Some prominent economists while deliberating on the debt problems of developing countries, have proposed that the international community supply the debt-affected countries with the expertise necessary for debt settlement and subsequent re-entry into regular self-reliant borrowing. (see Gustav Ranis, 1989).

From the point of view of the lender, the most fundamental motive for foreign investment is the desire of wealth-holders to maximise the value of their portfolio or net worth. However, Grubel (1968), is of the view that this basic motive has been clarified and extended by the inclusion of risk; and analysts often consider a risk-adjusted rate of return to wealth-portfolios as the main motive for foreign investment. Under this approach, foreign investment is possible even if the yield on assets abroad is expected to be lower than that on domestic assets simply because an imperfect correlation of changes in foreign
and domestic yields is expected to increase the risk-adjusted rate of return to the entire portfolio.

1.4. A brief outline on the trend in India’s External Borrowings:

India’s External Debt Stock was a mere $8.43 billion in 1970. In 1980, even after the second oil price shock, it was barely $20.7 billion. However, with the opening up of the economy in 1995, India’s external debt stock leapt to the phenomenal level of $99.06 billion in 2000 after peaking at $102.48 billion in 1994. As soft loans from bilateral and multilateral sources began to dry, India was forced into more and more commercial borrowings from the 1980s. As a result, while the 1970s witnessed a rapid growth of official debt, it was commercial debt which manifested the most captivating surge during the 1980s and 1990s. The significant build up of commercial debt, excluding private non-guaranteed commercial loans, grew from a mere $44.6 million in 1970 to $17.14 billion in 2000. In 1991, India, for the first time in its history, faced a reverse transfer of long term funds to repay the short term loans, and this trend continued for the greater part of the 1990s. Its borrowing from private sources increased from a mere 3.9% of the total debt in 1970 to 31.4% of the total external debt in 2000. The interest payments were greater than the principal repayments between 1989 and 1993. The bilateral credit declined sharply from 75.5% in 1970 to 25.2% of the total long term external debt in 2000. The external borrowings at variable interest rates increased from just 1% to 26% of the total external debt by 2000 signifying the commercialization of the external debt. These and other developments need to be viewed from India’s background.
1.5. India's Background:
Post-Independent India's development strategy was both inward-looking and highly interventionist, embodying a significant public ownership of heavy industries, complicated industrial licensing regulations, import protection, and financial repression. All the same, the macroeconomic policy effected steadiness through low monetary expansions and manageable public sector deficits [Chopra (1995)]. Consequently, inflation generally kept low except in response to the oil price shocks, and poor monsoons. The current account was manageable and there was a reasonable cushion of foreign exchange reserves.

Cerra and Saxena (2002) confirm that in the second half of the 1980s, current account deficits widened. India's development policy shifted from import substitution towards export-led growth, supported by measures to promote exports and liberalize imports for exporters. Import and industrial licensing requirements were eased, and tariffs were replaced with quantitative restrictions. Export growth was rapid, due to the initial measure of deregulation and improved competitiveness associated with the real depreciation of the rupee. However, the value of imports increased at a faster rate than that of exports. With the growth of domestic petroleum production slowing down and consumption growth remaining strong, the volume of petroleum imports increased by more than 40 percent between 1986-87 and 1989-90. The deterioration of the fiscal position stemming from rising expenditures contributed to the wider current account deficits. The growing current account deficits were increasingly financed by borrowing on commercial terms and remittances of non-resident Indians, which meant greater dependence on
higher cost, short maturity financing and heightened volatility to shifts in creditor confidence.

With the invasion of Kuwait by Iraq in August 1990, the price of oil rose sharply leading to a sudden spurt in the trade deficit. Many non-resident Indians living in the Gulf countries sharply reduced their remittances. Although a full blown balance of payment crisis in 1991 was triggered partly by external events, one cannot altogether ignore the weakness of domestic policies. As the monsoon-dependent volatile agricultural sector recovered abruptly, the domestic credit creation continued to expand stimulating domestic demand which in turn boosted nominal economic growth pushing up the inflation rate to over 12 percent in the early 1991. Significant government spending escalated the fiscal deficit to more than 10 percent of the GDP in 1991. The growing fiscal deficit and current account deficits accompanied by a high level of inflation did not make the rupee attractive to foreign investors. As NRI remittances and foreign lending began to dry, India had to rely on its foreign exchange reserves and gold reserves to bridge the balance of payment gap. Left with an alarmingly low level of $1 billion (two weeks worth of imports) India was forced to ship gold bullion to the Bank of England. India was on the verge of default on its foreign liabilities, but was able to recover with the IMF’s assistance in 1991.

The open trade regime of Rajiv Gandhi has had an adverse impact on the Indian economy. Marjit and Nirvikar (1993) observed that there is no strong evidence to support that exports were a spur to improved performance, including technological changes. Nambiar and Tadas (1994) found that the
booming import-intensive consumer durable sector worsened the current account balance. They conclude, “Trade is certainly the root cause of inverting the structure of Indian industry. If this is the kind of industrial restructuring that is being attempted, then the country is heading for long-run trouble. It will kick people from relatively high-paid to low-paid jobs.”

If their findings hold true, and if export growth is awfully low and inadequate, then in India, where “crowding out” of private domestic capital by various government debt instruments are a fashion of the day, the much needed curb on fiscal deficit will not be given much attention as it would be against political compulsions. In such a scenario, this trend in the fast track growth of external borrowing, especially commercial borrowing, will continue and pose a serious problem to future generations.

1.6. Rationale of the Study:
There is a saying: don’t look a gift horse in the mouth. The reason behind this saying is that the age of a horse is determined rather accurately, by counting its teeth. The message contained in this saying is, that since the horse is a gift of love, its age or its utility should not be considered. We are reminded of another horse, the Trojan Horse. It would be naive to apply the above message to present-day external borrowing, which like the Trojan horse, is charming and alluring, but which can come in the way of the economic development of a country. Therefore, this Trojan horse, will henceforth be called Tropital - coined by combining the two words Trojan and Capital, and implying that the external
capital is just like the gifted Trojan horse which has the potential of destroying the recipient country. The aim of this study, therefore, is to explore Tropital, assuming that there is no other alternative to external borrowing compatible with economic development; and to find out the optimum rate of interest camouflaged in this Tropital which is compatible with growth, and beyond which any external borrowing becomes disastrous for the economy of the borrowing country. A theoretical economic model, specifically dealing with the external sector is utilized to keep track of the capital borrowing country’s economy. As a comparative methodology, the main focus was to study the Indian economy in the light of the Mexican economy, at the initial stage.

1.7. Reasons for a Comparative Study of the Indian economy with that of Mexico:

External borrowings have always remained a major issue in Mexico, both intellectually and otherwise. Mexican history vividly narrates to us that its external borrowing has been a turbulent issue politically, economically and even emotionally. No country in the world has such a long history of external finance as Mexico, and that makes Mexico the most experienced economy in the world in dealing with external borrowing. Therefore, in order to comprehend the Mexican external debt problem, it is important to cull out that part of history which is linked to its external debt. (For a comprehensive in-depth details on the historical perspective of Mexico’s external borrowings, see Cockroft (1974), Gilly (1983), Burns (1986), Galearo (1988), Black (1988), Gleijeses (1991), Petras and Morley (1992))
Three great civilizations, namely, the Mayas, the Olmecs, and the Toltecs, preceded the wealthy Aztec empire which was conquered by the Spaniards in 1519-21 under Hernando Cortes. Spain ruled Mexico as part of the viceroyalty of New Spain for the next 300 years. Miguel Hidalgo, on September 16, 1810, wanted to make things right for the Mexican people by igniting a rebellion against the Spanish rule, and the Mexicans won their independence in 1821.

During the administration of Mexico's first president, Guadalupe Victoria, economic conditions deteriorated as government expenditures soared beyond its revenues. One of the government's major burdens was the assumption of all external debts contracted during the colonial period and the empire. To cover the revenue gap, Victoria accepted two hefty loans on hard terms from British merchant houses. The British had supported independence movements in Spanish colonies and regarded the loans as an opportunity to further displace Spain from Mexico as the New World's dominant mercantile power.

In 1846 the U.S., fulfilling the doctrine of Manifest Destiny, went to war with Mexico under the pretext of Mexico's non-payment of debt, and annexed a third of Mexico's territory, the area presently comprising the states of California, Nevada, and Utah, most of Arizona and New Mexico, and parts of Wyoming.

1 In 1845, John L. O'Sullivan, a democratic leader coined this term in an attempt to explain America's thirst for expansion, and Manifest Destiny became the rallying cry throughout America. Although the movement was named in 1845, the philosophy behind Manifest Destiny always existed throughout American History. In 1818, Andrew Jackson, led military forces into the Floridas, and in a systematic and ruthless manner captured several cities and forts. Americans who had moral reservations about the rough tactics of Jackson, soothed their consciences by reasoning that the Floridas were part of American territory; therefore, destiny intended that America should have them. Therefore, in 1845, the term Manifest Destiny conveyed the idea that the rightful destiny of the US included imperialistic expansion.
and Colorado under the Treaty of Guadeloupe Hidalgo, and also Texas at a
later stage. The US investment and trade grew steadily after 1850; and US
military intervention became common by the turn of the twentieth century.
Expanding commerce was more important than respecting sovereignty.

When Benito Juárez was elected president in 1858, he had to deal with
Mexican's external debt with other countries, including France. He decided to
use the little money that Mexico had to help the Mexican people, instead of
paying the money to France. In 1861, a moratorium on foreign debt payments
was signed through a Tripartite agreement between Britain, France, and Spain.

President Porfirio Díaz, upon his rise to power in 1876, was confronted with a
weak economy. Mexico remained saddled with a huge foreign debt and an
empty treasury. Mexico had a persistent current account deficit which caused
a serious balance of payment problem. In 1880, the next president, Manuel
González, in an attempt to meet his foreign debt obligations, withheld the
salaries of government officials, a move that led to a harsh campaign against
the president.

During the 1930s Mexico's foreign debts were renegotiated and the US
advanced further credits during World War II. Following the war, direct US
investment began to rise. A "suction-pump" effect remitted profits to the US,
weakened Mexico's conditions of trade, increased foreign debt obligations, and
siphoned off the country's foreign reserves. Between 1970 and 1976, during Luis
Echeverría Álvarez's presidency, there was an oil boom in the southern state
of Tabasco, and Echeverría emphasized Mexico's participation in the Third
World policies. When his Treasury Minister pointed out to Echeverría about the
difference between the internal and external debt, and that Mexico had reached
her limit in both, Echeverría removed his Treasury Minister. However,
Echeverría was forced to devalue the peso just before he left office.

During José López Portillo and Pacheco presidency (1976-1982) Mexico
became the world's fourth largest producer of oil and also one of the world's
leading debtor countries. López Portillo went on a spending spree that included
construction, public works, social welfare projects and subsidies on consumer
goods. This orgy of deficit spending was predicated on the assumption that oil
prices would continue to rise and that a never-ending flow of black gold would
easily satisfy Mexico's obligations to her creditors. But by mid-1981, Mexico
was beset by falling oil prices, higher world interest rates, rising inflation, a
chronically overvalued peso, and a deteriorating balance of payments that
spurred massive capital flight. This disequilibrium, along with the virtual
disappearance of Mexico's international reserves forced the government to
devalue the peso three times during 1982. Cut off from additional credit, the
government declared an involuntary moratorium on debt payments in August
1982, and the following month it announced the nationalization of Mexico's
private banking system. Inflation continued to be a menace, registering 63.7
percent in 1985, 105.7 percent in 1986 and 159 percent in 1987. Ultimately, the
Mexican economy contracted, and the standard of living fell. External debt was
renegotiated, and the government adopted economic austerity measures.
Again, in 1994, Mexico was forced to turn to the United States and the IMF for a $50bn bail-out package. In spite of the austerity measures and renegotiation of the debt to ease the crisis, in 1995 the debt stood at US$158.2 billion.

In January 1994, Mexico joined Canada and the United States in the North American Free Trade Agreement (NAFTA), and in January 1996, it became a founding member of the World Trade Organization (WTO). It increased corporate opportunities to take advantage of Mexico's large labour pool and weak enforcement of environmental regulations. A primary US negotiating objective was to loosen the Mexican state's monopoly over the petroleum and natural gas industries. While 100% foreign ownership was been considered unlikely in these sectors, the US won concessions allowing for 100% private financing of certain oil industry projects. In 1994, president, Ernesto Zedillo, was forced to devalue the Mexican currency shortly after taking office.

More recently, the present president Vicente Fox had to postpone a trip to Texas over a massive water debt Mexico owed to the US. The general observation is that the external debt continues to eat into the heart of the Mexican economy. At the same time, the banking system is swamped with frauds that are placing a weak financial system on the weakest shoulders of the millions of poor who must bail out the bank.

As can be seen above, Mexico has been intensively involved with the external debt problems for a good part of its history, and it is to India's advantage to learn certain lessons from the experience of Mexico in dealing with its own
external debt problems. Hence an in-depth comparative study of the Indian economy with that of Mexico was, first, thought to be much more appropriate than a general comparison of the Indian economy with one or more developing economies.

**1. 8. Reasons for the inclusion of some of the major developing economies:**

The external sector disequilibrium is identified as the central problem for both India and Mexico. In order to verify whether this is a common problem for other developing countries, this in-depth comparative methodology is extended to include two more Latin American countries, along with two Asian countries.

Among the Latin American countries, Argentina and Brazil are included in this group for study. These two prominent Latin American countries have had a period of fast growth combined with a greater inflow of external capital causing distress in their monetary policies. Their range of external borrowing experiences include increased borrowing from private sources, greater access to private capital markets, serious debt-servicing problems, highly fluctuating foreign exchange reserves, repeated financial and exchange rate crises, rising interest burdens, unmanageable fiscal imbalances etc. Both Argentina and Brazil went in for stabilization and structural adjustment programmes at the insistence of the World Bank and the IMF, and they have had their own experience of switching to flexible exchange rates, and flexibility in terms of full convertibility in both current and capital accounts. Brazil went to the extent of dollarisation of its currency, to its own bitter regret. Argentina is a die-hard
external borrower with a phenomenal growth in its external liabilities. If external
capital is the key to a speedy growth of the GDP in a borrowing country, then
what has been the impact of borrowing in these countries? This is the basic
question. In search of an answer to this question Argentina and Brazil have
been introduced into this study.

Among the Asian countries, both Indonesia and the Philippines are reckless
external borrowers. Both these countries have a huge foreign capital, and they
have deepened their external financial dependence over the years. Their
fluctuating growth did not deter them from bringing in Foreign Direct
Investment. The saving rates in these countries have been growing at a
phenomenal level. They have their experiences in handling or mishandling
external flows such as external aid, foreign direct investments, borrowing from
industrial country governments, borrowing from international capital markets
etc. Each type of inflow has different implications for repayments, and the
lessons from these countries will be of paramount importance to India. Both
Indonesia and the Philippines are characterized by huge short term and
Portfolio flows, and the obvious capital flight episodes. Besides, they have the
experience of an open economy by incorporating themselves into the world
economy through their trade relations, and have grown through the policies of
full convertibility, freely floating exchange rates, and flexible monetary policies.
Both the countries are well integrated with other Asian countries through their
trade. Hence, it was felt that it will be to India’s advantage to study the external
borrowing experiences of these economies.
As these economies have gone through their financial crises, an understanding of the external debt experiences of these countries is crucial to isolate the key crises variables to ensure that India does not follow the same policy designs, and walk into the same debt-traps. The lessons from these countries will ensure that policy mechanisms are in place to avoid any future potential crises. These lessons will also ensure that the financial systems are in order so as to absorb any disturbing trends in the Indian economy.

Today, China is a nation to reckon with. The consistency of the Chinese economy in maintaining a positive external sector balance, the consequent positive impact on its speedy GDP growth, and the overall economic development, caught the attention of this study. Hence China was also included as a focal point of comparison. China has a huge foreign capital, but it compensates for it by investing in other economies, and earns foreign capital through export surplus. Thus, what was originally thought to be a comparative study of India in relation to the Mexican economy, evolved into an in-depth analysis on the role of external liabilities in the economic development of these seven developing countries. If commerce makes a country's GDP grow, then these sample countries with their free trade, and greater inflow of foreign capital should have made their GDP grow faster than a relatively closed economy such as India. If free trade and an open economy are envisaged to speed up the process of economic growth, then a country like Mexico, with over 40 free trade agreements with a wide range of countries, should have grown manifold. But that has not been the case.
1.9. The Objectives, hypotheses and the methodology of the study:

1.9.1. The Objectives:

1.9.1.1. To find if there is a nexus between the current account deficit and the growth of external liabilities in the selected countries.

1.9.1.2. To find if the capital importing country has been able to digest the imported capital. If it is digested, what has been the resulting impact on the GDP growth.

1.9.1.3. To examine if the inflow of external capital has been beneficial or harmful to the development of a capital importing country.

1.9.1.4. To determine how much foreign capital is economically efficient and financially viable to a capital borrowing country, in the long run.

1.9.1.5. To analyze if there is displacement of domestic investment, domestic savings and domestic income as a result of the inflow of foreign capital.

1.9.2. Hypotheses:

The hypotheses used to test this study are as follows:

1.9.2.1. External capital is a boon to the capital borrowing country. Hence, the more the flow of external capital into a country, the greater the growth of the borrowing country.
1.9.2.2. External sector disequilibrium does not matter to an economy as the external sector equilibrium depends on exogenous factors, and these can at most be considered, as an appendix to an economy.

1.9.2.3. With the growth of foreign liabilities, the factor service ratios are stabilized. Hence, there is nothing like an optimal rate of interest on external borrowing that will hinder the economic development of a capital borrowing country.

1.9.2.4. There is no nexus between external liabilities and the current account deficit in the external sector of the capital borrowing country.

1.9.2.5. There is a positive relationship between the growth of the external liabilities and the GDP growth of a country.

1.9.2.6. External debt problems are caused by exogenous variables which a capital borrowing country cannot do much to alter.

1.9.3. Methodology:

1.9.3.1. An empirical approach is followed in the case of external borrowings and the various strands linked to them in chapter 3 and chapter 4. The correlation, if any, between external borrowings and economic development is attempted in chapter 5.
1.9.3.2. A comprehensive analysis is undertaken, to fix the volume and size of India's external debt, in a comparative trend analysis relative more specifically to Mexico, and also to a few selected countries such as Argentina, Brazil, Indonesia, China and the Philippines. When the volume of external debt keeps growing, it is important to analyse whether India is in a position to service its external borrowings. For this purpose, this study undertakes an analysis of India's debt sustainability.

1.9.3.3. In chapter 3, an empirical approach is followed to test if there exists a nexus between the current account balances and the foreign liability in each of the countries considered for this study through a linear regression analysis and the interpretation is provided in an exhaustive manner. The details of the methodology followed is also presented in chapter 3.

1.9.3.4. Again, in chapter 4, a similar regression analysis is undertaken to establish the link between the foreign liability and the GDP of each of these economies. Based on the scatter plots of the two variables, the least square method is followed with the Reciprocal Function in the case of India and Mexico, the Parabolic Function in the case of Argentina, and the Linear Function in the case of Brazil, China, Indonesia and the Philippines.

1.9.3.5. In order to test the relationship between the growth of foreign liability and the factor service ratios, a non-linear regression function is utilized in the case of all the sample countries except China. In the case of China, since the
scatter plot indicates two separate linear lines, two linear equations are utilized for the two periods, 1981-93, and 1994-2000.

1.9.3.6. A Simulation exercise is undertaken to find the amount of potential income that was lost during the past 30 years due to inadequate attention paid to the external sector, which brings out the amount of unnecessary external debt that was contracted due to faulty planning by these economies. The methodology followed in the simulation exercise is presented in a detailed manner in chapter 3.

1.9.3.7. Based on the theoretical model, utilised in chapter 4, this study projects the future of these economies in 2010, 2015 and 2020 with regard to the external liability and the GDP growth of the selected countries. The details of the methodology, and the working of the model is explained in chapter 4.

1.9.3.8. In order to capture the economic efficiency and financial viability of external borrowing, the objective criterion, the targets and the control variables are worked out with different options for each of the sample countries, and the consequent theoretical framework is provided with graphical presentation in chapter 4.

1.10. Data Sources, and the Time Period of study:
About the source of data, it should be noted that, fortunately, unlike in the past, there is considerable transparency with regard to India’s external debt data, and
the discrepancy between India's external borrowing data provided by the Reserve Bank of India (RBI), Government of India (GoI), World Bank (WB), Organization for Economic Cooperation and Development (OECD), Bank for International Settlement (BIS) and the Institute of International Finance (IIF). This discrepancy has been narrowed down to a large extent for the past few years.

However, the World Bank and the IMF use the “gross” liability concept which presents a better picture of the debt situation. [Arun Ghosh, 1993]. Besides, in order to have certain uniformity, more so for a meaningful comparison between India and Mexico, and the other selected countries, it was decided to rely entirely on data provided by the World Bank in the Global Development Finance Report 2002, the World Development Indicators Report 2002, the International Financial Statistics of the IMF, the RBI Statistical Handbook, the Status Report on India’s External Debt by the Ministry of Finance, the publications of the Reserve Bank of India, and the data from the central bank of Mexico, Banxico.

The time period of the study is from 1970 to 2000. However, certain current data beyond 2000 are also included, whenever required and possible.

1.11. Chapterization:

Today, the commercialization of external borrowing has reached such a low/high level (depending on perspective), that it poses a simple question: Is external borrowing meant to perpetuate the debt servicing activity of a needy
county, or for the country's economic development? This study reviews the vast output of literature that is available on external borrowing and presents it thematically in chapter 2.

Starting from the second half of the 1980s, India faced an acute Balance of Payment (BoP) problem, leading to the mortgaging of her gold reserves in the early 1990s. With the help of the World Bank and the IMF, India went in for structural adjustment and stabilization measures in the form of globalization and liberalization, climaxing in decontrol, delicensing, devaluation etc. Chopra and others (1995) point out that prior to 1991, capital flows to India predominantly consisted of aid flows, commercial borrowings, and nonresident Indian deposits. Direct investment was restricted, foreign portfolio investment was channeled almost exclusively into a small number of public sector bond issues, and foreign equity holdings in Indian companies were not permitted. Rangarajan (1993, 1994 and 1996) captures India's exchange rate crisis in terms of continued current account deficits, made worse by problems related to the First Gulf War. Foster (1986), quotes Magdoff, "... the fact is that during the postwar period the growth in service payments on the debt of the underdeveloped world has increased much more rapidly than has the growth of exports. Hence the burden of debt has become more oppressive and the financial dependency on the leading industrial nations and their international organizations such as the World Bank and the IMF has increased accordingly" (Magdoff, The Age of Imperialism, p. 154). Hence this study focuses on to the external sector disequilibrium, and traces out the nexus between external debt and current account imbalances in chapter 3.
If a country continues to borrow at commercial rates, year after year, just to repay the past loans and interest payments, how will the externally borrowed capital be used for economic development? Part of the answer to this question lies in the solution proposed by Evsey Domar, as early as 1950, that “the economic growth rate of the borrowing nation must exceed the rate of interest in order to avoid a reverse capital flow” (John C. Pool and Stephen C. Stamos, “The Uneasy Calm: Third World Debt - The case of Mexico”, *Monthly Review*, 36, no.10 (March 1985, p.9). Now with the globalization taking the centre-stage in the world economy, the heads of different governments have begun globe-trotting to hunt for external capital. This calls for an analysis of the role of external borrowing in economic development, which is taken up with a theoretical economic model in chapter 4. Chapter 5 lists a wide range of findings of this study and concludes with a number of policy recommendations.

1.12. Conclusion:
The preliminary enquiry into the external borrowing pattern of the selected countries indicate that the developing countries have deepened their external dependence over the years. Commercialisation of foreign capital has led a number of developing countries into deep debt-traps. Borrowing from abroad to meet the day-to-day domestic deficiencies merely implies forcing the future generations to pay for the present mismanagement. It is difficult to grasp the political logic of short-sightedness, centred around the political cycle of five or six years, which make our politicians and bureaucrats continue to borrow from abroad.

This study, which accesses an enormous mass of literature on external borrowings, tries to club together most of the literature and presents them in a thematic manner, in the following chapter.