CHAPTER I
INTRODUCTION

In the literature of development economics, there is a general consensus that the imports of capital and intermediate goods by LDCs for economic development result in to current account deficit and they finance it through borrowings from abroad. This leads to rise to external indebtedness of these countries. By 1982, LDCs owed over $500 billion to Western banks, Governments and international agencies. This amounted to a five fold increase in their indebtedness during the previous decade. By the end of 1990, the world’s poor and developing countries owed more than $1.3 trillion to industrialized countries.

There is nothing wrong with the growth of external debt. Several of the developed countries of today achieved their growth through external borrowing. Thus, the crucial question is how a country manages external debt without plunging into a crisis. A country might be tempted to default on debt service obligations when the accumulation of debt has been allowed at a pace and up to a level at which debt service obligations have exceeded the debt servicing capacity. For instance, in 1982, Mexico decided to stop its debt repayments preferring to use its foreign currency to maintain import levels and hence GDP and living standards. Between 1980 and 1987, 24 African nations experienced severe difficulties in servicing their international debt in at least 75 instances.

The debt servicing capacity of the developing countries have become a subject of concern for international lending institutions and debtor countries. In the mid-90’s, the IMF and World Bank launched the HIPC initiative to bring the debt of low income countries most of which are Sub-Saharan Africa to sustainable level.
There is a general agreement that this heavy burden of debt has been a result of large and persistent fiscal and current account balance of payments deficit, imprudent use of borrowed resources such as wasteful government spending, resort to borrowing for covering non-developmental needs, stagnation in export revenues, rising real cost of government borrowing. The excessive debt burden have a directly influences the economic and social development since an ever growing share of LDCs scarce resources is used to service external debt. In much of Latin America, most of the low-income Africa and in several other debt distressed countries, the prospects for economic development in the 1990's remained severely constrained by an unfortunate conjuncture of influences among which the burden of external debt is prominent. Governments of the poorest countries service debt to international creditors at great cost to people who lack food, clean water, housing, health care and education. Nevertheless, the problem associated debt service obligations can be avoided if the externally borrowed funds are productively utilized.

In India, it has been suggested that external debt is not worrisome. Since we have never defaulted on our debt repayment obligation, our position has been declared ‘safe’. But the sheer size of our debt and the changes that have taken place in its composition towards commercially contracted debt may pose serious problems in future.

India is one of the largest debtor among the developing countries if ranked by outstanding external debt stock. In terms of absolute level of debt, India was the third largest debtor in 1991 after Brazil and Mexico. India was ranked seventh by debt service in 1991 since large proportions is on concessional terms. The position improved and in 1997, India was eighth largest debtor country. Recently, India has been classified as a less indebted country.
The Problem and Objectives of the Present Study

India’s external debt grew rapidly during eighties particularly during the Seventh Plan period. After expanding by about $2.8 billion annually between 1980-81 to 1985-86 it grew by $6.2 billion per annum between 1985-86 to 1989-90. The annual growth in external debt in terms of dollars during Seventh Plan period (1985-90) was 15% p.a. The growth in debt was more than the growth in GNP and therefore, debt as proportion of GNP increased from 11.9% in 1980 to 27.4% in 1990. The terms of borrowings became harder during the decade of eighties. The structure of external debt changed in favour of lower proportion of concessional debt and higher proportion of commercial borrowings. The growth in external debt during eighties coincided with rising current account deficit which increased from 1.8% of GDP in 1980-81 to 3.2% of GDP in 1990-91.

At the annual meeting of Aid India Consortium held in Paris, in June 1990 the Government of India failed to secure the assistance urgently required to tide over the worsening balance of payments. In July 1991, international creditors began to restrict rollovers. Access to commercial markets dried up as credit ratings were downgraded. In June 1991, India’s foreign exchange reserves were about $1 billion (enough to meet only two weeks import requirement). As the payments crisis intensified in July 1991, India had to approach the multilateral credit agencies like IMF. India utilised its CFF, CCFF and ESAAF facility of IMF. Further, unconventional forms of borrowings such as loans against the pledge of gold, bonds targeting non-resident Indians with attractive interest rate differential, exchange cover, tax amnesty and transferability were resorted to. In spite of a severe import squeeze, balance of payments deficit had become unmanageable. It was obvious that India could not live beyond its means unless it was able to find creditors.
While throughout this difficult period, India honoured debt-servicing obligations, the unsustainable burden of debt choked off the growth rate of the economy at below 1% in 1990-91. It is in this context that the present study has attempted to seek answer to India’s debt problems. The balance of payment crisis in 1990-91 is to be analyzed because in real life, the debt servicing difficulties generally manifest themselves as liquidity crisis in balance of payments. But the main objective of the study is to examine the long run debt servicing capacity of India.

It is in this context that the present study has attempted to investigate into the factors that caused the liquidity crisis in India in 1991 and the factors that govern debt servicing capacity.

**Objectives**

The main objectives of the study are as follows:

1. To examine the growth in India’s external debt and the long term debt servicing capacity.
2. To examine the causes of India’s balance of payments in 1991 and India’s response to the liquidity crisis.
3. To examine the effect of external financial resources on domestic savings and investment.
4. To analyse the changes in the pattern of trade and balance of payments with a view to successfully service debt.

**Hypotheses of the Study**

The central hypothesis of the study:

“Long term debt servicing capacity of India has improved pari passu with the increase in external debt obligations.”
As a corollary to the above mentioned central hypothesis, the present study attempts to test the following sub-hypotheses:

1. External borrowing supplements domestic savings and investment.
2. The external payments crisis of 1991 was due to unfavorable debt structure. Unfavorable debt structure has resulted into increase in the level of external debt and debt servicing burden.
3. Growing fiscal deficit has resulted into continuous trade deficit.

**Time Period and Justification of the Study**

The study covers a period of 27 years (1970 to 1997). The time period is sufficiently long to analyse the long term debt servicing capacity. The study assumes significance in the context of growing concern for the problems created by India's high external debt. This study is encouraged by the lack of country specific studies on the external debt-economic growth relationship. However, the studies generally analyse the effect of debt developing countries and they concentrate on the impact of debt on investment or savings level rather than on economic growth. The studies relating to India are generally found in the form of articles. Some of the studies available have concentrated on specific aspect like debt rescheduling or short terms debt management etc. Such studies do not attempt to analyse the causes that affect the changes in the debt servicing capacity of a country. It is considered more appropriate here to investigate into the factors that cause a debt crisis and how a debtor country can successfully emerge from a crisis. The time period takes into account the high savings phase, growth miracle of eighties, liquidity crisis of 1991 and the post reform period. Therefore, it is long enough to cover the aspects like changes in economic policies which affect the macro-economic variables like growth, savings, investment, imports, exports etc.
Methodology and Sources of Data

This study is mainly qualitative in nature. Simple tools like ratio’s percentages have been used in this study. However, for the purpose of analysing the data so collected, statistical tool like regression has been used to determine the effect of external finance on savings, investment, exports. The causality test (Granger Test) has also been used to find out the causality between macroeconomic variables like growth and savings, fiscal deficit and trade deficit.

The data for the study are obtained from national as well as international sources. The national sources of data include Government of India’s Economic survey, National Accounts statistics Five Year plans and Reserve Bank of India (RBI) Report on currency and finance, Handbook of Statistics on Indian economy. As far as international sources are concerned data have been obtained from World Debt Tables, World Development Report published by World Bank, International Financial statistics.

One of the main problems affecting studies of India’s external debt has been the lack of comparability of data between the official RBI/MOF estimates of the total debt and the figures published by foreign financial institutions like World Bank and IMF.

The study has depended to a considerable extent on data from Economic Survey, Government of India & RBI publications. But the data on external debt, exports etc have been used from World Debt Tables also. The reason is that the coverage of data on external debt in World Debt Tables is exhaustive compared to Government of India publications. The World Debt Tables data are in dollar terms & refers to calendar years. It has been specified in the text wherever data from world
debt Tables and the Indian publications are used. The use of data on this pattern does not lead to different conclusions.

**Definitions**

The following terms would be used frequently in the present study. Therefore, it is considered desirable to define them.

**Developing and Underdeveloped Countries and Less Developed Countries**

The low income are variously described in development economics. They are alternatively called as ‘under developed’ or ‘developing’ or ‘less developed countries’. The word ‘developing’ has become the most favored term though it inadequately describes the nature of the economy in poor countries. In the present study, we shall use the terms ‘under developed’, ‘developing’ and ‘less developed countries’ interchangeably. This has now become a standard practice with economists dealing with the problems of third world countries.

**Foreign Capital and Foreign Aid and External Assistance**

In the present study it became imperative to distinguish between various forms of foreign capital. Foreign capital takes two forms: a) Private foreign investment, b) Foreign Aid.

Private Foreign Investment can take two forms: (i) Direct foreign investment refers to those investments which are made to create some kind of a permanent interest in an enterprise in another country. This investment takes the form of acquisitions of equity shares in new or existing company in host countries, leading to expansion of the equity base. (ii) Indirect foreign investment or portfolio investment takes place
when the nationals of one country purchase shares or debentures floated by industries in some other country.

Foreign aid can be defined to include “all official grants and concessional loans, in currency or in kind which are broadly aimed at transferring resources from developed to less developed nations on developmental and/or income distributional grounds.”

In the present study, the terms aid and foreign capital are synonymous and as such they are used interchangeably. The aid from developed countries have come generally in the form of loans. Therefore, now-a-days the term foreign aid is not frequently used, instead external debt is used because the aid took the form of loans.

**Economic Development and Economic Growth**

The terms economic development and economic growth need to be distinguished from each other. A country may experience development in terms of rising investment in different sectors of the economy with or without growth because of the long gestation and low returns typically associated with early stages of economic development. Whereas, the growth may take place without development because economic growth implies an increase in national income. The economists though admit the differences between the two also suggest that in essence their connotation is the same. This study, however, is concerned with the Indian economic performance and external debt in the long-run. In the long-run, growth and development are synonymous as such they are used interchangeably in the present study.
**External Debt**

India has accepted in principle the IWGEDS\textsuperscript{11} definition of gross external debt which at any given time is the amount of disbursed and outstanding contractual liabilities of residents of a country to non-residents to repay principal with or without interest or to pay interest with or without principal.

Therefore, the stock of external debt as defined by World Bank is external debt which is owed to non-residents of a country and is repayable in foreign currency. It also distinguish debt in terms of its maturity, type of creditor terms and conditions the classification on debt on above mentioned basis explained in detail in Appendix I

**Fiscal Deficit**

In simple terms, fiscal deficit is budgetary deficit plus market borrowings and other liabilities of the Government. In other words, fiscal deficit is equal to Revenue Receipts plus Capital Receipts (only recovery of loans and other receipts) less total expenditure.\textsuperscript{12} It should be noted that in economic literature and to a certain extent by international institution the term budgetary deficit is used to represent fiscal deficit. The internationally accepted meaning of budget deficit is it should represent a net addition to aggregate purchasing power in the hands of the economy and not just a transfer thereof from the private to public sector.

It measures that portion of Government expenditure which is financed by borrowings & drawing down of cash balances. When the drawing down of cash balances is zero, the fiscal deficit measures an addition to the liabilities of Government of India. In the presence study generally Fiscal Deficit of the central government is used.
Organisation of the Study

The whole work is divided into eight chapters. The first chapter, the present one, states the problem of external debt in India. The methodology and the major terms employed have also been stated here.

The second chapter is addressed to the review of literature on external debt and economic growth relating to India as well as LDCs. A justification for undertaking the present study is also provided in this chapter.

The third chapter presents the analytical framework. The analytical framework has been developed to assess the debt servicing capacity of India.

The fourth chapter gives an idea about growth of debt, changing debt structure, and rising debt service obligations.

The fifth chapter examines the relationship between external debt, domestic savings, investment and growth in income.

The sixth chapter examines the changing pattern of foreign trade and India’s balance of payments in relation to burden of external debt. The seventh chapter deals with various aspects of debt servicing capacity necessary conditions for keeping debt in manageable limits. The eighth chapter presents summary of conclusions.
Notes and References


2. The Enhanced HIPC Initiative and the Achievement of Long Term External Debt Sustainability, International Monetary Fund, April 15, 2002.

3. Ibid pp. 15.

4. These studies are reviewed in Chapter 2, see:


10. A Discussion of growth and development are found in the following studies:


