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INDIA'S EXTERNAL DEBT[1]

by
RAVI I. GULHATI

TOWARDS the end of the Third Plan, it became clear that India was having difficulties in servicing its external debt. This situation was not unique. The foreign indebtedness of developing countries had been a matter of international concern for many years. Multilateral renegotiations of debt contracts had taken place on many occasions during the Fifties and early Sixties to provide relief to Argentina, Brazil, Chile and Turkey. The debt problem had figured prominently on the agenda of UNCTAD meetings in Geneva in 1964 and in New Delhi in 1968.

Little is known outside government circles about the history or the nature of the Indian debt problem. There is no dearth of statistics in government publications or in reports by the Estimates Committee of the Lok Sabha. However, the significance of this information is seldom clear. The relationship between debt and other aspects of the Indian economy are not generally understood. And yet, it is important to build a body of informed opinion on these subjects. What should be done about the country's external debt is a question which requires consideration not only by government officials and experts but also by students of international relations, parliamentarians, journalists and other readers of this Quarterly. An attempt is made in this article to present the main facts in bold relief, eschewing the technicialities and the mumbo-jumbo of high finance. I will also try to summarize the present policy of the Government of India and its major creditors. From this juxtaposition of fact and policy it should be possible to get a glimpse of the future prospect not only for India's debt but also for the rate and pattern of the country's development.

When India gained independence she had little external debt and large external reserves, mainly in the form of sterling securities. At the outset of the First Plan, these reserves amounted to the equivalent of U.S. dollars 2.1 billion. Nearly two decades later, on the eve of the Fourth Plan, these reserves had dropped to a level of $767 million while external debt had climbed up to $6.3 billion.[2] This transformation in India's international position—from being one of the important creditors of Great Britain to being the biggest debtor country in the developing world—was the result of deliberate policy. The rise in the foreign debt was not the result of either absent-mindedness or financial irresponsibility. It was a calculated by-product of the strategy for economic development conceived and implemented by Indian planners with the full knowledge and blessing of the Lok Sbaha.

Briefly, the strategy was to raise the rate of investment in the economy as quickly as possible, supplementing national savings with external resources. A consistent feature of successive five-year Plans was the setting of investment targets above the level permitted by savings expected to materialize within the economy. Looked at from the viewpoint of the balance of payments, the planners counted on imports which were much bigger than the projected level of exports. The planned resource-gap between investment and savings (or that between imports and exports) was to be financed by drawing down the reserves, foreign borrowing and by external transfers in the form of grants. The idea was to build a momentum in the economy. As the Second Plan put it "It is the crossing of this 'threshold' at a time when living standards and the saving potential are low that calls for a measure of external assistance to supplement domestic resources" (page 11).

The conception of the strategy was one thing; its implementations was someting else. Policy-makers had to contend with unforeseen circumstances as well as simple errors in Plan estimates. During the First Plan, there took place a sharp increase in the rate of investment (from 5.5%of national income to 8.0%; see Table I) and some increase in the savings rate. The resource-gap turned out to be much lower than forecast and it was not necessary to draw down reserves or to increase foreign debt very much. Another big jump in the rate of investment took place during the Second Plan, with the savings rate trailing behind. It seemed that planners had grossly under-estimated the resource gap. The balance of payments got into serious trouble. To finance the deficit, reserves were drawn down by nearly $1.3 billion. The Aid India Consortium was established in 1958 to rescue the Indian economy. The foreign debt rose by $1.1 billion. The resource gap during the Third Plan averaged more than $ 1 billion per annum as the investment rate continued to move far ahead of domestic savings. The country's external debt increased by $ 3 billion. In the period after April 1966—the so called Plan Holiday—both investment and saving rates suffered a set back. The economy, it seems, lost a part of the dynamism generated during the Fifties and early Sixties. Most observers agree that while India has made substantial progress during the last two decades, no 'threshold' has yet been crossed. Many of the deep-seated problems of poverty and technological backwardness remain unsolved.

TABLE I

Resources-Gap, Savings and Investment

	Resource Gap		*Net Investment as Per cent of National Income*		*Domestic Savings*	
	Planned	*Actual*				
	(million dollars)					
First Plan	1,680	317	5.5	8.0	5.5	7.0
Second Plan	2,310	4,000	8.0	11.0	7.0	8.5
Third Plan	5,567	5,150	11.0	13.5	8.5	9.9
1966-67		1,312	12.7		9.2	
1967-68		1,192	11.4		8.0	
1968-69		597	11.3		8.0	
Fourth Plan	3,019		11.3	14.5	8.0	13.2

Meanwhile, we have incurred external debt to the extent of $6.3 billion. To some people the absolute size of the debt figure will be frightening. However, a few relationships between external debt and other economic parameters will put things in the proper perspective. The external debt in 1969 was about 13% of GNP, 83% of gross domestic savings and nearly three times the export earnings of the country. Of course, the external debt does not have to be repaid all at once. Debt service payments during 1967-70 were just over 1% of GNP, 7% of gross savings, nearly 30% of export enarings and 48% of gross foreign aid disbursements. From these comparisons, it should be clear that debt service payments were not a major claim on total GNP or gross savings. However, they did pre-empt more than a quarter of foreign exchange earnings. This relationship between annual debt service payments and foreign exchange earnings constitutes an important aspect of the debt problem and we will return to it later. It is also clear that the reverse flow of debt service from India to her creditors is almost

half the total amount of foreign aid. In other words, on the basis of the 1969-70 relationship, a net transfer of resources to the Indian economy of one dollar requires almost two dollars in the way of new loans or grants. This, too, is an important aspect of the debt problem.

Who are the major creditors of India? The most important amongst them is the United States government (see Table II) represented in New Delhi both by Treasury officials and employees of the Agency for International Development. Over a long period, India has figured prominently in discussions on foreign aid in the U.S. Congress and many American economists have made a career out of analyzing the behavior of the Indian economy. We absorbed nearly one-fifth of the total bilateral assistance extended by the U.S. in recent years. The second rank in the league of creditors is held by the World Bank Group of institutions. Their presence in New Delhi is in the form of a resident mission which prepares detailed reports on the financial and economic health of the country. Up till 1960, lending to India was through the International Bank for Reconstruction and Development, more commonly known by its acronym, IBRD. These loans carried interest rates of 5-6% and were for periods varying between 15-20 years. With the establishment in 1960 of the International Development Association (IDA)—the soft loan agency affiliated with the World Bank Group—the IBRD began to recede into the background. At one time India was the biggest borrower from the IBRD but now that position is held by Mexico. Instead, India became a prominent user of IDA funds which carry a negligible interest rate and a repayment period of 50 years. During the initial years of IDA operations, India absorbed more than one half of total lending by IDA.[3] In time IDA was compelled to ration the amount which could be lent to India to about 40% of the overall total for all developing countries.

TABLE II

Structure of Debt and Debt Service 1969

	Per cent Distribution of Outstanding Debt	*Debt Services as Per cent of Debt Outstanding*
Bilateral: Official	*72*	*6.4*
U.S.A.	35	2.8
U.K.	9	7.8
Germany	8	9.9
USSR	8	14.0
Others[4]	12	8.5
Multilateral: Official	*20*	*5.2*
IDA	13	0.8
IBRD	7	12.9
Suppliers' Credits	*8*	*28.4*

Next in importance as India's creditors are the United Kingdom, Germany and the Soviet Union. The USSR, of course, is not a member of the Aid India Consortium. The Soviet Union's relationship with the Government of India is strictly bilateral in character. Typically, loans from the USSR (as well as other East European countries) carry a low interest rate of of 2.5% but they have to be repaid within 12 years. In many cases payments on Soviet credits begin even before projects financed by these

credits have come into full production.[5] Total debt service payments to the USSR constitute a relatively high share of debt outstanding (see Table II). However, this comparison is not altogether accurate as it fails to take account of a distinctive feature of the relationship between the Soviet Union and India. Debt service payments to the Soviet Union are transferred in the form of Indian exports under the framework of trade and rupee payment agreements between the two governments. The precise economic consequences of these arrangements have never been established and remain a matter of some controversy between the Government of India and her western creditors. However, the fact remains that Indian exports to the USSR have increased rapidly and debt service payments to that country have not impinged much on the limited supply of free foreign exchange. The relationship with the Soviet Union has elements of mutuality and reciprocity which are lacking in India's economic contacts with western countries. Soviet loans to India are tied to that country's exports and our debt service payments on these loans are tied to Indian exports. We cannot use Soviet loans to buy articles in third countries. Reciprocally, the Soviet Union cannot use debt service paid by India for purchases in third countries. The bulk of loans from western countries are also tied to procurement in these countries but debt service payments on these loans have to be made in freely convertible currencies.

It is not easy to measure precisely the terms on which India has borrowed from different external sources. The question of terms is not simply a matter of interest rates, grace periods (the interval during which loan repayment is not necessary) and maturity schedules (the sequence in which repayment is to be made). The effective cost of borrowing also depends on the severity of restrictions on the use of the loan, the extent to which prices of articles purchased with the loan are uncompetitive, the mode of transfer of debt service and the like. Nevertheless, it is possible to conclude that

(a) The share of grants and grant-like transfers in the total resource flow to India has declined sharply. Correspondingly, the share of loans rose from 43% in the Second Plan to 61% in the Third Plan.[6] This upward movement has continued in recent years.
(b) The financial terms on loans have softened considerably. Actual interest payments as a proportion of debt outstanding, declined from 4.4% to 3.4% during the Third Plan. Similarly, the average life of the debt had lengthened from about 13 years to 23 years.[6] These trends have continued in the second half of the Sixties.

Everything considered, the Indian debt structure is not an unfavourable one. The Government has followed a prudent policy in limiting the share in total of suppliers' credits and other loans from private sources. At present the proportion of debt in this category is only 8% (see Table II). This policy of restraint has been in effect since the first foreign exchange crisis in 1957-58, to avoid the building up of onerous service payments. It is this relatively low share of supplier's credits that distinguishes the Indian debt situation from that prevailing in Latin America.[7] Official loans from multilateral institutions constitute one-fifth of the total Indian debt. The terms of multilateral loans have softened appreciably as IDA has displaced the IBRD. Official loans from bilateral sources constitute the remaining 72% of the debt. The financial terms of US loans have been soft for many years.[8] Conditions attached to loans from the UK and Germany have improved recently.

The diagnosis of India's debt difficulty depends on the frame of reference adopted by the analyst. If the subject is approached from the standpoint of a conventional banker, the conclusion will be that India has "over-borrowed", and that the country should either scale down national expenditure or raise national savings. In any event, we should reduce reliance on external resources and stabilize the level of the foreign debt for some considerable time. If following this prescription means a setback in the growth rate of the economy, accentuation of unemployment or a persistence of idle industrial capacity, that is just too bad. To the banker, the concept of credit-worthiness is sacrosanct and everything must adjust to the imperatives embodied in loap contracts.

Alternatively, the subject may be approached from the standpoint of international development and welfare. In this context, the common goal of creditor and debtor governments will be to speed up the tempo of development, to improve the efficiency of the growth process and to raise the standard of living of the poor. Foreign loans and grants are instruments for achieving these objectives. Financial conditions on which loans are extended should be respected so long as they are consistent with development considerations. If debt servicing obligations impede development, they should be revised in an appropriate framework of consultation. Viewed in a developmental framework, India has hardly "over-borrowed". Most observers agree that the total resource flow from abroad—grants and loans—has been quite modest, considering the size of the economy. On a per capita basis, India's receipts of net official aid have been strikingly low compared to the general average for developing countries.[9] Net aid financed 19% of total Indian investment during the Second Plan and 22% during the Third. Besides, the resource transfer to India has had a relatively short history—not much more than a decade.

India started its development from an extremely low base—an abysmal per capita income far short of $100, a meagre saving rate of about 5% of national income and many sociological as well as institutional handicaps which cannot be described in statistics. The export structure was dominated by commodites—jute, tea, cotton textiles—out of favour with demand conditions in the world economy. A country such as this cannot be expected to achieve a decisive transformation in a decade. Economic development in such a context requires a sustained transfer of foreign resources on a rising scale for many decades.[10]

What then is the genesis of the Indian debt problem? A part of the difficulty arises from having borrowed too little and for too short a time. This may sound like a puzzle but it is true. The transfer of foreign resources is shrinking prematurely. In 1968-69, the net transfer was one-half that in the preceding year (see Table I) and it declined sharply once again in 1969-70. India's debt problem is not only the result of a shrinking flow of aid, it is also caused by the inappropriate form in which aid is extended. The tying of resource transfers to currencies of creditor countries as well as to the foreign exchange component of specific investment projects creates a serious dilemma for managers of the Indian balance of payments. While the need is for foreign exchange to import raw materials, spare parts, semi-manufactures, services and a wide assortment of machinery of small value, the bulk of foreign aid cannot be used for these purposes. Meanwhile, debt service payments pre-empt a very large portion of the country's export earnings in free foreign exchange which could otherwise be used for the above-mentioned items. This divorce between needs and availability has come to be known in Finance Ministry circles as the "cashew-nut problem". The reference

is to the anomalous siuation in which resources are available to buy costly, sophisticated machinery and capital equipment for which there is little need, but an acute shortage of cash to buy East African cashew nuts for processing in India for export to western countries.[11]

It is not my intention to assert that the Indian debt problem is entirely the result of the short-sighted policies of creditor countries. Such a view would be untenable. Our present predicament is partly the result of extra-economic events—the rise in defence expenditures after the war with China in 1962 and with Pakistan in 1965—and partly the consequence of errors in economic policy as well as administrative inefficiencies. We have been far too optimistic about the speed with which the import bill can be reduced and far too pessimistic about the feasibility of expanding exports. These biases have coloured the evolution of economic policy. Although the framework of policy was revised during and after the Third Plan, the new emphasis on export promotion was not sufficiently far-reaching. Incentives to produce for the home market remain much more powerful than those for exportation. To this imbalance should be added the fact that the new export measures have not been implemented as vigorously as one would wish.

The value of Indian exports showed no decisive upward movement throughout the, Fifties when the debt service payments, starting from zero, climbed up to about $90 million. During the Third Plan exports rose at an average rate of about 4% per year while debt service payments shot up to $260 million by 1965-66. Subsequently, the value of exports increased at an average rate of 3-4% per year, while debt service obligations continued their upward march to a new high of $580 million by 1970-71. Export earnings, net of debt service payments, showed very little expansion during the last two decades. The sharp increase in debt service combined with a rather sluggish rise in exports, meant that India's capacity to import based on her own resources, was severely constrained. The Chart shows the movements of exports and debt service as well as the percentage relationship between these two magnitudes during the last 15 years.[12] The level of the debt service ratio (the percentage of exports absorbed by debt service) is a good rough measure of the burden imposed on the Indian economy by foreign borrowing. This burden would have been much lighter had exports picked up some momentum.

One can also take issue with other aspects of Indian economic policy but this brief discussion on the question of exports should suffice. The important point is to learn from a review of past experience. Basically, socio-economic development is a process of learning and innovation at all levels—on the farm, in the factory, in the political party and in the government secretariat. If our foreign creditors wish to participate in the development game, they, too, must have an open mind. Nobody has a monopoly of wisdom.

Despite a serious deterioration in the foreign exchange position at the end of the Third Plan, the Government of India did not interfere with the smooth discharge of debt obligations. The idea of delaying these payments or defaulting on them was either not seriously considered or firmly rejected.[13] A beach of contract does not go well with our sense of fair play or our style of government. Furthermore, a default in debt obligations could have prompted retaliation by creditors in the form of cancellation of disbursement on existing loans, refusal to negotiate new aid, restriction of trade credit and possibly an embargo on trade.

The Indian Government requested its creditors for debt relief to alleviate

a very strained foreign exchange position. The strain resulted from a variety of factors—unprecedented drought conditions, the slowdown of disbursements following the suspension of aid in 1965 and a setback in export earnings. The emphasis of the Indian request was on quick action in response to an emergency. Although individual creditor governments provided a measure of relief, the Aid Indian Consortium as a whole did not act till February 1968. It took many months of preparation, extensive report-writing, numerous discussions and visits to capitals of Consortium countries to agree on principles and work out the precise details of the debt relief programme. The World Bank, in its capacity as the Chairman of the Consortium, played an active role in this phase. The services of a prominent official of the French Treasury—M. Guillaume Guindey—were commissioned to negotiate the final package.

In the end, the Consortium decided on debt relief to the extent of $100 million for each of the three years 1968-69 to 1970-71, enabling India to postpone the payment of roughly 1/5 of the scheduled debt service for these years. The techniques used by creditor countries to provide relief varied but in principle the concession amounted to a postponement for 10 years without interest. India did not receive any additional aid; debt relief was counted as part of total assistance in the framework of the Consortium. However, aid in the form of postponed debt service released free foreign exchange. As such, it was a distinctly superior kind of assistance in the context of the Indian balance of payments.

This action of the Consortium established a precedent of considerable importance. Perhaps, this was the first occasion on which the debt problem was viewed in a long-term developmental context instead of being treated as an adjunct to a short-run stabilization exercise or as a response to a bankruptcy situation. Previous multilateral debt re-negotiations were conducted as if they were barely within the pale of respectability. The impression was that creditors viewed the "sorry business" with the utmost distaste. By contrast, the Aid India Consortium considered the matter as a genuine problem of development finance, one that required a re-assessment of past policies and practices both by creditor governments and the debtor country.

Although, the Consortium's handling of the Indian debt problem constituted a major departure from past practice, the final outcome fell considerably short of what was required. It was recognized that the Indian economy required net aid on a substantial scale for a considerable time but the Consortium was unable to provide any assurance that such assistance would be available. In fact, the volume of the net transfer diminished sharply during the 3 years in which debt relief was provided. Unless action is taken to reverse this movement, the chapter on international aid to India will soon come to an end. Presently, the Consortium is making a new study of India's debt problem and aid prospects.

What then should be done about the country's external debt? We seem to have ruled out the option to default. It is worth mentioning that no Indian political party—left or right—has advocated this course of action in open debate. Perhaps, the commitment to constitutionalism and the long tradition as a trading nation make it difficult for us to think in terms of reneging contracts. Another option that has been rejected is the recourse to large-scale borrowing on short or medium-term from foreign suppliers of machinery. This is because India produces most kind of machinery (except ships, aircraft, etc.) and there is little need to import it on foreign credit. Also, the dangers of such external borrowing are quite clear to policy-makers.

They are fully aware of the predicament of several developing countries—in Latin America and elsewhere—who have gone down the suppliers' credit route.

The Fourth Plan talks of the spirit of self-reliance and postulates a declining net resource transfer. It is visualized that by the end of the Fifth Plan (1978-79), the economy should generate a surplus of resources sufficient to cover interest charges on the foreign debt. This is an admirable perspective from the standpoint of self-reliance but one that forecloses the option of (a) raising total income faster than 5.7% per annum and (b) allowing per capita private consumption to increase faster than 2.6% per annum.[14] The choice of the planners is probably based on a shrewd judgement regarding the outlook for foreign aid. The delay in replenishing IDA's resources and the acrimonious debate in the US Congress are straws in the wind. The United States seems to have become "aid-weary" even though the development journey of many poor countries in Asia and Africa is only half begun. These are the "long-haul" cases which are being given a distinctly short-run treatment.

If this is the shape of things to come, India will have to face the consequences as best as she can. The outstanding debt will level off at the end of the 'Seventies and begin its downward course thereafter. By the end of the present century we will have reduced our liabilities substantially. If, on the other hand, the present disenchantment with foreign aid proves temporary, we may witness another resurgence of foreign aid (and thereby external debt) allowing India, as well as other developing countries, the option of accelerating their rate of development. Perhaps the wise course of action in the light of the uncertainty surrounding foreign aid is to be prepared to live with a dwindling flow and at the same time to be fully equipped psychologically and in a policy sense to seize hold of opportunities for additional aid, should they arise.

Washington D.C.
November 1971

Footnotes

1. The views expressed in this article do not necessarily represent the official position of the World Bank, with whom the author is associated. The author wishes to thank Robert Cassen, M.R. Shroff and C.S. Swaminathan who kindly commented on the paper.
2. External public debt outstanding on a disbursement basis. To this should be added another $1.6 billion of debt which had been contracted but not yet disbursed. External reserves had touched a low of $524 million in March 1965. The dollar equivalents in this article are in terms of the parity prevailing before the recent devaluation.
3. This prompted some one to quip that the addreviation IDA really stood for the "Indian Development Association" the remark was funny but the underlying sentiment was no laughing matter.
4. Includes Japan, Canada, Czechoslovakia, Netherlands (in order of importance) as well as other countries.
5. Estimates Committee, Fourth Lok Sabha; *Utilization of External Assistance*, August 1967, p. 145.
6. Government of India, *Economic Survey*, 1966-67, p. 51.
7. The share of suppliers' credits in total Latin American debt is 25%. It is as high as 38% in Argentina.

8. In many ways the US official bilateral aid was extended on quite generous terms (interest rate 2.5%, grace period 7-8 years, maturity 33 years, grants 58% of total aid) in the mid-sixties. Since then a noticeable hardening in the financial terms of US assistance has taken place, although in comparison with bilateral programmes of other countries, they still remain generous
9. Per capita net official aid to all developing countries averaged $4·1 during the mid sixties compared to $ 2·5 for India, $4·2 for Pakistan, $7·1 for South Korea, $ 15·7 for Chile and $36.6 for Jordan. *Annual Reports of the Development Committee of OECD.*
10. The formal argument underlying this proposition is presented in Dragoslav Avramovic & Associates; *Economic Growth and External Debt*, 1964, ch. V.
11. Of course, the problem is not confined to cashew nuts. More generally it concerns a variety of purchases from other developing countries which cannot be financed with foreign aid.
12. Debt service payments shown in the chart do not take account of relief provided by the Aid India Consortium.
13. Pakistan has recently suspended debt service payments to its bilateral creditors, except where the transfer can be made in kind. (See World Bank *Annual Report 1971*, p. 52). Such unilateral action by a debtor government in difficulty is not unprecedented, although no case of a technical default—a definite refusal to pay—has occurred in the period after World War II.
14. See Fourth Plan, p. 31. Some economists of the Jana Sangh persuasion have contended that it is possible to achieve much higher growth rates of income than those in the Fourth Plan without foreign aid. However, these arguments have not carried conviction with the main body of Indian economists and policy-makers. One wonders whether those who call for increased self-reliance speak for the mass of the poor in India.