A STUDY OF INDIA’S EXTERNAL DEBT PRE AND POST LIBERALIZATION

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ABSTRACT
Indian Economy has a distinct journey demarcated by liberalization. This article attempts to take a look at India external debt position before liberalization and the changes in the same post liberalization.

Keywords: External Debt; Pre-Liberalization External Debt; Post Liberalization External Debt

INTRODUCTION
Since independence till today the journey of Indian economy can be distinctly divided into specific periods that are pre and post liberalization. Whereas, the pre-liberalization period had a socialistic, centrally planned, restrictive and controlling approach the post liberalisation period has open market economy, minimum restrictions, and liberalized approach to achieve overall development goals. Fewer than two different sets of conditions the various factors influence the Indian economy in different ways as per the peculiar financial situations of the time affecting the external debt.

OBJECTIVES
To understand India external debt position before and after liberalization

Pre Liberalization
Before independence colonial regime had perused the economic policies catering to the needs of industrial revolution in Britain, which was considered to be exploitative by the then Indian leaders. Hence, post-independence policies tended toward protectionism, strong emphasis on import substitution, industrialization under the state monitoring, and state intervention at the micro level in all businesses; especially in labour and financial markets. The business regulations and central planning included large public sector, steel, mining, machinery, railways, water, telecommunication, insurance, power plants etc. in government run sectors. Elaborate licenses, regulation and accompanying red tape commonly referred to as ‘license raj’ were the order of the day making it very difficult to set up a business in India. The then Indian planners adopted 5-year plan methodology of Soviet Union.

During the first 5-year plan, 1951-56 the growth rate of GDP never rose more than 3-3.5% and capital growth rate was even poor to 1.3% of GDP. India had to import oil, defence merchandise, other absolutely necessary merchandise like machinery for heavy industries as against no export worth the name. With external debt received from colonial regime India was compelled to again go for external debt to fulfil the requirements. The economic planners at that time mainly focussed on two sectors, namely infrastructure and agriculture. In order to give impetus to agriculture merely 246 irrigation projects were started in right earnest. However, in both these sectors the return on investment has a long gestation period. Investments for these projects came in the form of aid or concessional loans with little or no interest. During the second and third 5-year plan there was a huge increase in external debt because of the reasons below.

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1. Fiscal deficit year after year
2. No return on investment from infrastructure.
3. No return on investment from agriculture sector due to inordinate delay in completion of irrigation projects.
4. Increasing imports in oil and other materials
5. Great increase in import of defence sector due to war situation.

During this period the external debt came in the form of tied aid. The tied aid meant either source tied or project tied. The source tied aid meant a binding on receiving country to purchase goods and services from specified sources at the rates quoted by them which was always higher than market rates. The project tied loans did not allow diversion of funds and the donor country had a decisive say in perception, planning and pricing of the project. In effect the tied aid forced India to pay high costs for purchasing machinery with total dependence on donor country for spare parts. About 66% of bilateral loans during second 5-year plan and 83% of bilateral loans during third 5-year plan were tied aid kind of loans.

In short, the aid received by India during the first three 5-year plans was:

<table>
<thead>
<tr>
<th>Period</th>
<th>Aid received (in million dollars)</th>
</tr>
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<tbody>
<tr>
<td>1951-56</td>
<td>280.9</td>
</tr>
<tr>
<td>1956-61</td>
<td>1611.1</td>
</tr>
<tr>
<td>1961-66</td>
<td>4240.7</td>
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The fourth 5-year plan was shifted to 1969-74. During this plan there was a steep rise in import of defence sector due to 3 wars, i.e. 1962 China war and 2 wars with Pakistan in 1965, 1971. The world also witnessed a steep rise in oil prices in 1972-73. Even though India survived this shock, India had to go for short term loans on stiffer terms and the total foreign aid received during this period was $4698.5 million.

1975-80 was a period of political turbulence in India as well as Indian economy. The total share of India in long term credit from financial markets increased from 0.7% in 1977-78 to 2.9% in 1980-81. 1979 oil price hike was a major reason but India could not expand its exports and did not put a cap on imports. This situation took the balance of payment position to unmanageable limits. The current account deficit began to build up and India had to borrow more external debt from IMF under the extended funds facility.

Around 1980-81, Indian government took a decision to open up hither to closed economy in a small and cautious way. It was an effort to promote exports and give a little leeway to imports. But in reality the exports did not rise much because of sluggish global economy while the import of high profile luxury and electronic goods in a big way created a huge trade deficit pushing India to more external debts. By now the era of concessional loans had to come to an end and India had to borrow at higher interest rates. The gradual opening of external commercial borrowing window increased commercial debt obligations from $464 million in 1980-81 to $2196 million in 1985-86 to $7067 million in 1991-92. Thus India was borrowing high interest loan to pay up no or little interest loans. From 1980 onwards, India’s deficit financing needs were mostly met with outside assistance. The External debt kept on aggregating and ultimately reached a level of 38.7% of GDP in 1991-92 landing India into a deep debt trap. India had a foreign exchange reserve for 2 weeks only. Mortgaging 67 tonnes of gold as collateral for bailout package extended by IMF helped India avert this crisis.

Thus the concessional loans gave way to tied aid loans and ended with high interest loans, loans for repayment of loans and Indian economy was in deep trouble in 1991. IMF gave helping hand in this near terminal crisis but forced India to accept structural adjustment program.
Post Liberalization Period

The post-independence industrialization was mainly under government control and the domestic industry, not being opened to global markets, had no clue about global competition, qualitatively and quantitatively. Therefore the sudden exposure to global markets as per the structural adjustment program of IMF forced the Indian manufacturing and production sector to import cheaper and better quality raw materials and improvise upon the quality of their products. Thus the hitherto protected domestic market went through a very tough phase of growth and competition. The pre-market economy during the 90s on one hand helped the industrial sector to evolve on its own and rise to the global expectation on the other hand it forced the domestic economy towards raising external debts.

Liberalisation also allowed current account and capital account convertibility. The convertibility allowed rupee to gain its own value as per the global exchange market forces because, import payments and export proceeds could now be made outside the country or brought in India without any currency restrictions. The exchange market reforms carried out by the Indian government was the most thoroughly prepared and executed policy. A system of liberalized exchange rate mechanism was introduced during 1992-93 budget. As per this system a dual exchange rate was fixed under which 40 % of foreign exchange earnings were to be surrendered at the official exchange rate while the remaining 60% to be converted at market determined rate. Thus proceeding cautiously India attained full convertibility on current account on 19 August 1994. The reserve bank of India, further liberalised invisible payments and accepted obligations under Article viii of the IMF, under which India was committed to forsake the use of exchange restrictions on current international transactions as an instrument in managing the balance of payments. Many other relaxations of restrictions on current accounts were announced in subsequent years.

The convertibility was planned in a broad time frame of 5-year period consisting of three phases, 2006-07 first phase, 2007-09 second phase and 2009-2011 third phase as per the recommendations of Tarapore Committee II. The financial crisis of 2008 and the continuing recessionary trends forced almost all the countries world over to backtrack on the liberalisation process and resort to protectionist measures.

The full capital account convertibility would have brought with it,

1. Exponential rise in import prices, resulting in cost push inflation for domestic economy
2. Liberalised market exchange rate system if not properly managed would lead to depreciation of domestic currency and investors losing confidence in that economy.
3. The consequence being uncontrolled and heavy capital outflows pushing the economy to the brim of major financial crisis.

This is what exactly happened in case of South East Asian countries, Thailand, Malaysia, Indonesia and South Korea.

Has this not happened – even without implementing full capital account convertibility – with Indian economy to a great extent?

1. Great rise in import costs creating extreme trade imbalance and consequent cost push inflation reaching at time above 11% (2013).
2. A heavy, unabated currency value fall since or even before 2008 crisis. The major rupee depreciation was in 2012-13.
3. Subsequent capital outflow and fall in FDIs and FIIs.

The unabated rupee depreciation took place after the convertibility of current account since 1994 and increased the value of external debt stock, causing heavy draw down of foreign exchange reserves and exchequer in a bid to meet international payment obligations. Further the rupee convertibility in
current account also made external capital flows more vulnerable due to fluid and volatile global economic scenario.

There are 3 types of capital flows.

1. Borrowing from world capital markets, governments and multi-lateral lending institutions.
2. Portfolio investments mostly from FIIs.
3. FDIs

Borrowing from world capital markets and institutions like IMF and World Bank necessarily require a favourable report from credit rating agencies. There are several criteria and scales on which the rating agencies test the repayment capacity of any country. First and foremost would obviously be comfortable balance of payment position, lower and manageable trade and fiscal deficits and also progressive GDP growth. These indicators project the health of economy and hence debt sustainability. It is therefore very interesting to note that even with its continuing balance of payment problem, India has always managed to borrow heavily except in some extremely bad economic crisis periods like 1991. However for capital inflows in the form of debt or investment require healthy economy and conducive environment which was not there prior to liberalisation. Even after liberalisation there was substantial growth in foreign investment only in broken periods that too mostly from FIIs portfolio investments. FIIs with their volatile nature are not at all a dependable capital inflow.

Liberalization in some sectors like banking with opening of FCNR deposit scheme for NRIs was already done in an effort to attract foreign currency and to build strong forex reserves. These schemes did attract foreign currency deposits but obviously needed to be paid with interest on maturity. The advantages of these schemes are:

1. For NRI depositors the higher exchange rates fetched more rupees.
2. For Indian economy it was a planned and known repayment to be made as per scheduled time.

Hence even after liberalization the stable capital inflows were of debts. The opening of global markets for India accelerated the activity of mergers, acquisitions and takeovers. The mergers and acquisitions most of the times did not involve any actual currency transaction and warranted mere transfer of shares and other holdings on paper. However the takeovers involved actual currency transactions and could turn the volume of capital flows upside down. These activities could be done to and fro for the country. The Indian companies, to thrust ahead in the global competition are going in a big way to acquire foreign companies to tap new markets. This activity can take capital funds outside India. Until 2004-05 the growth rate of capital outflow was moderate but during last 5 years it reached above 22000 million dollars. This voluminous capital outflow has proved unhealthy for India’s capital account.

After liberalisation foreign investors now hold a major chunk of almost every sector which is evident with the rapid expansion of multinationals. The heavy capital inflow in portfolio investment has added to foreign exchange reserves but eventually it is speculative investment to earn profits. Anytime this invested money can go to a higher profit destination and there are no controlling clauses or rules for the same. Hence the FIIs can make the currency susceptible to global exchange market volatility and uncertainty. A heavy outflow can weaken and depreciate the currency.

The multinational companies have increased hold on domestic industries by way of FDIs are in a strong position to have a major say in their management and policies projecting a new phase and method of neo colonialism. Just like old colonial rule a huge voluminous transfer of profits are taken away by these companies.

Accumulation of external debt particularly in developing countries like India could lead to a problem of original sin (OSIN). The concept of original sin is a by-product of liberalisation. Post liberalisation these developing, under developed, poor and emerging market economies find themselves exposed to
global markets and are unable to raise foreign loans in their own currencies. Subsequently the available external debt in itself is extremely costly for them. This results in excessive foreign borrowings and becomes heavy burden for their economy. This burden pushes their economies to crash down situations with even a small global financial crisis.

The foreign currency denominated external loan depreciates the real exchange rate of their own currency because then there is a heavy demand for foreign currency by way of loan. The devaluation of their own currency reduces the purchasing power of the domestic output. The lower value of domestic currency on one hand raises the value of stock of external debt and on the other makes repayment or servicing of debt costlier leading to default situations on their external commitments.

This is exactly what has happened for India. India was on the verge of default only once in 1991. But the South East Asia economies were ripped apart due these crisis and these countries declared inability to meet the international payment obligations.

Inability of developing countries to borrow in their own currency, currency mismatchs, misuse or improper use of costly external debt and capital flight were the reasons for these situations. Hence the problems of original sin would occur as a repercussion of weak domestic economy, inability to manage current account and fiscal deficits and also balance of payment position. These economies then try to raise funds in whatever way possible.

Here the role of IMF and World Bank comes into picture as these two are supposed to help poor and undeveloped economies in their periods of financial crisis.

**Overview of The Charter Of IMF**

1. To foster global growth and economic stability. To provide policy advice and finance and to work with developing nations to achieve macro-economic stability and reduce poverty.
2. To promote international monetary co-operation and exchange rate stability.
3. Facilitate balanced growth of international trade.
4. To provide resources, to help members in balance of payment difficulties and to assist with poverty reduction.

The IMF has 188 member countries. It is an independent international organisation which has its own charter, governing structure and finances. Its members are represented through a quota system broadly based on their relative size in the global economy. The IMF is a specialized agency within the meaning of United Nations charter and its relationship with the United Nations is defined by a special agreement between the two organisations.

The IMF with its role as a global financial crisis manager keeps track of the economic health of its member countries through economic surveillance. It alerts them to oncoming risks and provides policy advice. It provides finance to countries in difficulty and also assists with technology and training to improve their economic management.

The role of IMF is being questioned and criticised since late 1980s-early 1990s for the following reasons.

1. Between 1980 to 1996 a package of economic policy reforms in the name of structural adjustment program was imposed on more than 80 developing countries.
2. There was never a real capital transfer from the lending agencies/countries to the borrowing countries as there were always conditions attached under ‘tied aid’ programs. In fact a reverse flow of funds took place by way of imports of spare parts or other products from the donor countries as per the conditions of the tied aid.
3. IMF forced countries like Argentina, Indonesia, South Korea and Thailand to declare private loans of these countries’ residents as sovereign loan. Thus the economies of these countries
having current account surpluses we were pushed into severe financial crisis and IMF promptly forced structural adjustment programs on these economies. Had the IMF not intervened the regular market forces would have taken their course and the domestic lending agencies would have recovered the amount from non-resident borrowers of these countries in due course.

IMF and World Bank appear to have come under fire mainly because of its structural adjustment program. It is argued that all the countries facing balance of payment crisis were provided bailout packages and exactly identical economic policies were imposed on them without considering their individual economic and financial problems. The strict adherence to SAP (Structural Adjustment Program) consequently meant IMF and World Bank guiding the borrowing countries how to run their individual economies. The main aim of SAP is said to be putting the balance of payment crisis hit countries back on track. After SAP these countries were expected to rarely face balance of payment crisis and current account deficit and fiscal deficit would be within manageable limits. These countries would require minimal foreign assistance.

The IMF emphasised that the SAP would be beneficial for the developing countries by way of fair trade. The fair international trade was supposed to mean equal opportunities for all the countries and fair value of exports to these under developed countries. However exactly opposite has happened over the years for these undeveloped economies.

1. Instead of reduced foreign debt their debt burden has increased greatly over the years after implementing SAPs.
2. These crisis hit countries are facing unequal and unfair trade practices.
3. Instead of increasing exports, their exports are either stagnant or have sowed down.
4. Imports have posted manifold increase and these countries are facing raising import and reduced export and hence huge trade deficit.
5. These imbalances are pushing them towards even more severe balance of payment crisis thus defeating the very purpose of SAP and liberalised policy.
6. Another argument put forth is that rich G7 countries which dominate the functioning, regulation of UN, IMF and World Bank are using the poor developing countries as their markets in the wake of economic and market stagnation on their domestic fronts.
7. Also the abundant natural resources and cheap labour of Asian and African countries make them more prone to and are being exploited by rich and advanced countries. This bringing in neo-colonisation to the fore.

John Stiglitz in his book, ‘Making Globalization Work’, inks that the manner in which liberalisation is imposed by way of SAP on poor economies world over is making poor countries poorer and rich countries richer. He says that even within a country, the gap between the rich and the poor is ever increasing because of SAPs and liberalised policy.

As per the SAP program, India was asked to bring down fiscal deficit to 5% of GDP which was though difficult at that time was eventually good for the Indian economy. Another condition as per SAP was the elimination of subsidies. Full convertibility of Indian currency brought down the value of rupee and increased the external debt stock value by 89.3%. Such was the voluminous impact that the stock rose from 99700 crore rupees in March 1991 to 137700 crore rupees in December 1991.

Logically Indian should have put some restrictions on unnecessary imports in an effort to overcome balance of payment crisis. But the IMF recommended the opposite course. Hence the measures failed to revive balance of payment position and India’s external debt kept increasing.

The SAP increased foreign investments in India in the form of FDIs and FIIs. Since these investments especially the portfolio investments are for profit making and hence more fluid. The increase in FII
investments accounted for 70-75% of total foreign investment after SAP implementation and has not proved to be beneficial for India’s balance of payment because of its volatile and fluid nature.

A study by Walter Fernandez, K.T Chandy and Arundati Roy Chowdary for Jesuit Network on India’s foreign debt October 1998 has penned down all these clauses in IMF’s SAP implementation pointing out that its very fundamentals are wrong.

Liberalization in principle is said to be foundation for global integration wherein free trade, free flow of labour, capital and unrestricted access to world market is envisaged. However the GATT agreement on investment and other IMF conditions get access to the borrowing countries economy and consequently to the capital and simultaneously allow rich countries to put restrictions on the use of their capital. Thus at times the borrowing countries are used as dumping markets for HYV seeds and tonnes of wheat. Allowing the free import of seeds has affected domestic agriculture sector adversely. All though the import of seeds is free it is sold at a high price to farmers. The IMF also puts a condition to reduce or eliminate all subsidies may it be for fertilisers, seeds, education or health. IMF also put a curb on all such sovereign expenditure so that the governments does not face cash crunch while servicing the costly external debt. These conditions put the agriculture sector of India doldrums and its agro based economy is in real crisis. In this situation reversal of subsidies in agriculture sector has brought many a farmer on the verge of bankruptcy.

CONCLUSION

In short most of the economics researches, papers, and data suggest the following for external debt seen in the perspective of pre and post liberalisation and role of IMF

1. India has been facing balance of payment crisis, current account and fiscal deficit problems since its independence with external debt inherited from the British rule.

2. The three wars 1962 China war, 1965 and 1971 Pakistan wars and 2 major oil shocks pushed India into heavy spending on defence and oil imports. This further worsened balance of payment crisis.

3. The continuous balance of payment crisis subsequently resulted in heavy and ever increasing external borrowings on harder terms, landing India into a debt trap.

4. The 1991 crisis was a precipitation of the continuous downslide of economy since independence. This crisis brought liberalisation in the form of SAP, with an intention to bail

Source: http://www.theglobaleconomy.com/India/External_debt
out India on continuous balance of payment crisis and arrest the increasing external borrowings.

5. However India is still having precarious balance of payment at times comfortable and at times alarming. This is simply because after liberalisation, the external account has become susceptible to external capital inflows and outflows (FDIs and FIIs). Fortunately post liberalisation, the invisible receipts by way of IT and service sector have posted a huge raise and have helped in managing current account deficit and balance of payment position.

6. FIIs are unproductive and are bound to be withdrawn suddenly in extremely high volumes, being speculative in nature.

7. Post-liberalisation the propagated free trade, pave way for the rich advanced countries to use India as dumping market for their products and commodities. The anti-dumping measures are now proving to be a bone of contention between the trading countries. Thus the very purpose of free trade under liberalisation has gone awry.

8. The role of IMF and imposition of SAP are being criticised for following reasons.
   a. On the pretext of liberalization and with the format of SAP, IMF is interfering individual nations’ economies, in fact at times tying to run their countries.
   b. The structural adjustment program has deepened the economic crisis of these poor countries instead of bailing them out – the start examples being Mexico, Indonesia, Argentina and Thailand.
   c. IMF forcing some countries to declare private loans as sovereign loans and making these countries pay the liabilities in full, pushed Argentina, Thailand and Indonesia into a debt trap.
   d. The IMF puts crisis hit countries into one umbrella of SAP format and does not take into account the strengths and weaknesses of individual country’s economy.
   e. SAP enforces elimination of subsidies especially in social sector thus depriving the poor of the right to education, potable water and healthy living conditions.
   f. IMF advocates free international trade but ignores the basic disparities between rich developed countries and poor undeveloped economies.
   g. Thus IMF is blamed for pushing the global economy towards more imbalance and inequality.
   h. With reference to India, the liberalisation and SAP turned agro based structure of Indian economy into a market oriented structure wherein out policy makers are left with no choice but to ignore the basic strength of our economy that is the agriculture sector.

9. Thus the liberalisation that the IMF propagates should actually allow the countries to decide and frame their own economic and financial policies. The economic planners of the individual countries know the strength and weaknesses and can formulate their policies to achieve growth and stability.

10. India has been making serious efforts to come out of its economic problems and as succeeded to some extent. However it’s still not fully back on track and needs guard and vigilance on the part of government and economic planners.

11. Finding a better alternative to IMF and World Bank can prove very effective.

12. Goal orientation and clear cut guidelines can prove beneficial if the BRICS banks comes up with an alternative.
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