EXTERNAL DEBT MANAGEMENT: CASE STUDY ON INDIA

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1.1 External Debt-Definition

According to a working group formed by four organizations namely The World Bank, The BIS (Bank Of International Settlements), The IMF (The International Monetary Fund) and The OECD Organization For Economic Co-operation And Development External Debt can be defined as follows-

"Gross External Debt is the amount, at any given time, of disbursed and outstanding contractual liabilities of residents of a country to nonresidents to repay principal, with or without interest, or to pay interest, with or without principal"

Gross Debt is the stock of liabilities, on which debt service is calculated.

1.2An overview

Foreign Borrowing allows a country to invest and consume beyond the limits of current domestic production and, in effect, finance capital formation not only by mobilizing domestic savings but also by tapping savings from capital surplus countries. Foreign borrowing can lead to more rapid growth. However, if a country borrows abroad, it must also introduce debt management as a major policy concern. Inappropriate and excessive foreign borrowing will generate debt service obligations that will constrain future policy and hence growth. Global capital markets allow enterprises and governments in capital scarce countries to borrow from capital-abundant countries, where the market interest rate is lower. World capital markets, in effect, increase the interest that lenders in the capital-abundant countries can earn and reduce the interest paid by borrowers in the capital-scarce countries. International lending can thus, increase economic welfare in both the borrowing and lending countries. For capital-scarce counties this means expansion of capital formation and higher optimal borrowing. The objectives of debt management policy are to achieve the benefits of external finance without creating difficult problems of macroeconomic and balance of payments stability.

1.3 External Debt and Macroeconomic Considerations

How foreign borrowing affects macroeconomic stability can be best understood in the context of production, consumption, savings, and investment. In a closed economy (no foreign trade), production comprises goods and services for personal consumption (consumer goods), capital goods (buildings, plant and equipment, inventories used by enterprises), and goods and services used by the government, which can be both for consumption (for current use) and for investment. Where there is foreign trade, production also includes goods for export; imports are a supplement to domestic consumption, for investment, for government use or for exports.

There is a relationship between production and income. Put simply production creates incomes equal to the value of output. The government in taxes takes some income; some is taxed; some is saved by the private sector; the balance is spent on consumption. Foreign borrowing is the excess of imports of goods and services over exports and net borrowing creates debt, which can be repaid if exports exceed imports. In the absence of foreign borrowing (exports and imports are equal), private sector investment plus government spending is limited by the level of private sector savings and taxation. Economic growth, of course, could be accelerated with foreign borrowing, permitting imports to exceed exports and at the same time, investment plus government expenditures to exceed savings plus taxes. There are standard indicators for measuring the burden of external debt: the ratios of the stock of debt to exports and to gross national product, and the ratios of debt service to exports and to government revenue. Although there is widespread acceptance of these ratios as measures of creditworthiness, there are no firm critical levels, which, if exceeded, constitute a danger for the indebted country. However, the World Bank Staff has proposed a set of parameters, which it uses to demarcate "moderately" and "severely" indebted countries. Countries with a rapid export growth can support higher debt relative to exports and output. Heavily indebted, however, are vulnerable to severe macroeconomics shocks-sharply higher interest rates in the lending countries, for instance, or simply lenders cutting back on their commitments. Faced with these pressures, countries must then adjust by cutting private investment, decreasing government expenditures and or increasing government revenues.

1.4 Important Aspects Related To External debt Management

a) Financing Techniques

Countries have a limited ability to support external borrowing. At the same time, the supply of finance is also limited. Consequently, borrowers must choose the best combination from the available sources of external finance to suit the needs of individual projects-and of the economy as a whole. The country wishes to minimize the problems in servicing new debt, while making maximum use of grants and foreign loans on concessional terms. These are clearly the cheapest from of financing, but their availability is generally restricted to the poorest developing countries; and even for those countries, they are inadequate to meet needs. A maximum leverage can be obtained from concessional financing by combining it with other types of financing. Other sources of credits are export financing and loans from international commercial banks.

. Authorities should ensure that credits from financial markets are part of a package that provides the best possible external financing mix for the economy, as well for an individual project. For projects the best mix could mean one with: (1) maximum concessional loans or maximum market finance (2) the maximum capital that can be rolled over easily, or (3) the minimum debt service due in the years before returns materialize. Authorities must also ensure that the aggregate financing package meets national financing priorities, This involves an assessment of such aspects as: the sources of fiancé ,including the amounts that can be borrowed and the prospects for future supply; the currency composition of foreign borrowing that would minimize exposure to exchange rate fluctuations; the exposure to interest rate fluctuations over the life of the loan; and the impact of new borrowing on the structure of debt service obligations.

b) How much to Borrow

The amount that any country ought to borrow is governed by two factors: how much foreign capital the economy can absorb efficiently, and how much debt it can service without risking external payment problems. Each factor will depend on the quality of economic management. Borrowings can be on different terms and in different currencies, which complicates the policy decision. There may be uncertainty too about evolving debt-servicing capacity. Interaction between debt servicing capacities, the type of finance, and the borrowing decision increases in complexity as the number of loans increases.

c) Managing Risk

Countries are sometimes exposed to BOP shocks arising from unfavorable changes in the relative prices of exports and imports, Suppose that a country's exports earnings are in dollars and its foreign debts are repayable in yen A deterioration in the exchange rate of the dollar vis-a-vis the yen will add to the debt servicing obligation of the borrowing country. Fluctuations in commodity prices, foreign exchange rates and world interest rates are largely beyond the control of countries. It is possible to hedge against this risk. Managing risk is an important part of public debt management

d) Knowing The Debt

Information on external debt and debt service payments is essential for the day-to-day management of foreign exchange transactions as well as managing debt and for planning foreign borrowing strategies, At the most detailed level, the information enables central authorities to ensure that individual creditors are paid promptly; at more aggregated levels; debt data are needed for assessing current foreign exchange needs, projecting future debt service obligations, evaluating the consequences of further future borrowing and the management of external risk The component of external debt statistics include details of each loan contract and it's schedule of future service payments, figures on loan utilization, and the payments of debt service obligations. From these data elements summary figure on foreign borrowing, outstanding debt, and projected debt are assembled. The resulting statistics provide inputs for budget and BOP projections

1.5External Debt Management In Mexico: The Mexican Experience

Introduction

It could be argued that the Mexican experience in late 1994 and 1995 was one of the first economic and financial crises in the new context of integrated global financial markets. In recent years, several economies have been subject to a severe disruption of their capital markets, which in some cases ended in speculative attacks on their currencies. In a world in which capital flows rapidly among countries, unprecedented negative externalities on domestic financial systems, and on the growth prospects of an economy, may be important. Furthermore, these externalities can easily be magnified in the presence of weak financial systems and macroeconomic disequilibria. Thus, a clear understanding of the risks and challenges that emerging economies face in global financial markets is needed . There are challenges that the volatile environment of capital markets poses to domestic financial systems and to the sustainability of economic reform. It is argued that to benefit from capital inflows as a complement to domestic saving, solid macroeconomic fundamentals and a sound financial system are required. A claim is made that prudent management of external debt and liquidity plays a significant role in fostering macroeconomic stability. In addition, the paper suggests that once firm fundamentals and a healthy financial system are in place, the damaging effects of increased volatility in international capital markets on the domestic economy would be reduced significantly. In that case, the proper use of international reserves, market flexibility and the presence of contingent credit lines or other types of financial insurance agreements would represent an adequate response to a liquidity crisis. The Mexican record since the abrupt devaluation of the peso at the end of 1994 shows the importance of pursuing policies geared to macroeconomic and financial stability and market flexibility, and the relevant role that proper management of external debt and liquidity plays in the overall economic strategy. The paper is organized as follows: the next section provides an overview of the challenges that capital flows have posed to emerging market economies. The Mexican experience since the early 1990s is an interesting case study. This is so because prior to 1994 Mexico absorbed substantial capital inflows, but the 1994–95 crises was accompanied by a drastic scarcity of such flows. Nevertheless, sound policies and macroeconomic stability allowed Mexican agents to return to international capital markets in record time. The challenges that huge swings of capital movements posed the Mexican economy are relevant to analyze, as is the debt management strategy that followed. Thus, the following section presents the main elements of Mexico’s debt strategy. Particular emphasis is given to the importance of ensuring a balanced profile of debt amortization. It is argued that even though governments might aim to procure a balanced and well diversified debt structure, market conditions might interfere, and on occasions cause important deviations from the attainment of that goal. Mexico’s 1997 credit line with international financial institutions and the recently negotiated financial package are presented in some detail. The final section includes some considerations regarding debt management, liquidity provisions and financial stability that need to be addressed in order for emerging markets to be better equipped to face an uncertain environment.

Debt management strategy

The design of an adequate strategy for public debt management should include proper consideration of a number of questions. Among them, several come to mind: (a) how much public debt should be issued in domestic markets and how much in foreign capital markets? (b) What should be the currency denomination of new public debt issues? (c) What is the optimal maturity structure of public debt? (d) Should governments consider redeeming in advance some issues and refinance them on different terms? (e) Should public debt be issued at fixed or variable rates and (f) should public debt issues be directed to a particular segment of the market (financial institutions, other institutional investors, corporate sector, etc)? Most of these choices entail a trade-off between the level and the variance of debt costs and are highly dependent on both the domestic macroeconomic context and conditions in international markets. Nonetheless, the debt management strategy has important implications for the economy as a whole. Good liability management should result in lower borrowing costs and unimpeded access to international capital markets, while minimizing any crowding-out effects on private sector borrowing. The choice of the specific characteristics of the debt portfolio involves difficult decisions. While on a pure cost-based analysis it is tempting to choose short-term over long-term debt, the latter might Brady bond spreads for different emerging market economies have behaved similarly, though at different levels, in the midst of financial crises or increased uncertainty. Thus, the liquidity of emerging markets' securities and the collective behavior of institutional investors make the financial authorities' tasks more difficult, particularly since systemic risk may rise swiftly. A thorough discussion of these issues, as well as some policy recommendations, is presented in the final section. Over the past decade, capital mobility has increased many times over and its main features have also changed, especially those related to the allocation between foreign investment and traditional lending. Mexico, as a recipient economy, has witnessed those events. Total capital inflows to Mexico grew from a yearly average of US$ 2 billion in 1987–88 to $36 billion in 1993. In the latter year, foreign investment amounted to 920/0 of capital inflow. The 1994 crisis caused an important reduction of these flows, to $23 billion in 1995. Given that foreign investment for that year turned out to be negative, loans from abroad represented more than 1000/0 of total capital inflows. For 1996–97 capital inflows were on average $10 billion per year. However, it should be emphasized that total foreign investment represented more than 2000/0 of that amount. That is, foreign investment more than compensated for the decline in indebtedness. For 1998–99 capital inflows are estimated to have averaged $16 billion per year, with total foreign investment amounting to 770/0 of the inflows. Foreign direct investment grew from $4 billion in 1993 to $11 billion in 1994 and has kept a stable level of around $10 billion per year since then. On the other hand, portfolio investment has shown more erratic behavior. Having reached a peak of $29 billion in 1993, it turned negative in 1995 (–$10 billion) and for 1996–99 has averaged under $1 billion per year. The important reduction in the flows of foreign portfolio investment to Mexico since the crisis of 1994–95 is primarily explained by the adoption of a floating exchange rate regime. This regime has proved to be extremely helpful in inhibiting short-term foreign investments by reducing their expected return, once adjustment is made for exchange rate risk. Without the implicit guarantee to portfolio investment provided by the semi-fixed exchange rate regime, foreign direct investment started to play a more dominant role in financing

Mexico's current account deficit blurred. The Exchange Stabilization Fund prevented the liquidity crisis from turning into a solvency crisis, whose repercussions would have been far more devastating.

Prior to 1994, both debtors and the banking system in general were in a fragile situation. Past due loans had increased substantially, and the lack of proper provisioning started to erode banks'

capital. In addition, some commercial banks faced severe problems that were not revealed in their financial statements, and, in some instances, banks disregarded existing regulations and proper banking practices (Mancera (1997)). In this environment, the effect of the currency depreciation, rising inflation and higher interest rates on the credit service burden seriously jeopardized the Mexican financial system. At that time, the materialization of systemic risk and its impact on the economy were major concerns. Faced with this situation, the government and the central bank implemented a comprehensive programme to deal with the banking sector crisis, without derailing monetary policy from its main task of procuring the reduction of inflation. The successful mix of policies ensured the consistency of Mexico's macroeconomic framework and allowed the economy to recover and rapidly return to international markets. An important element of the overall strategy was to provide liquidity to commercial banks to comply with their external obligations. To this end, a dollar facility was made available to them by the central bank. Thus, Banco de México played the role of lender of last resort for commercial banks at a time of distress, making foreign exchange available to banks through a specially designed credit window. These dollar-denominated loans were channeled through the Fund for the Protection of Savings (FOBAPROA).At the beginning of April 1995, the dollar-denominated credits granted through FOBAPROA reached a maximum of US$ 3.8 billion. However, the high level of interest rates purposely charged on such credits induced a rapid amortization, as banks sought other sources of financing. By 6 September 1995, the 17 commercial banks that had participated in this scheme had already repaid their credits. In this sense, the programme achieved its stated purpose, namely that of providing temporary assistance. Once international markets were reopened to Mexican agents (July 1995), the main objectives for the immediate future included the refinancing of the Exchange Stabilization Fund in the market, have a smaller refunding risk and thus be preferable in the end. That is, a better schedule of amortizations lowers country risk and finance costs over the medium term, both for the government and for the private sector. Likewise, borrowing domestically may turn out to be more expensive than in external markets. Yet borrowing in domestic markets could trigger a rapid development of these markets and pave the way for a solid corporate domestic market in the future. In sum, a good liability management strategy is one that helps minimize the cost of borrowing over the medium and long term. The objective is certainly not to save the last basis point in each transaction, but rather to bring down the overall borrowing cost. Thus, a smooth debt amortization profile is crucial. There is no doubt that emerging economies have to work hard to ensure desirable characteristics in the debt profile, even if initially costly. At the end of 1994, Mexico faced a liquidity crisis accompanied by a very high refinancing risk. This forced the country to seek support from the international community to confront the heavy short-term debt burden. Economic policy was oriented towards rapidly re-establishing macroeconomic stability. This was the only way to stop capital flight and gradually restore Mexico's access to international financial markets. To deal with the scenario just described, a comprehensive package of policy measures was put together. The stabilization programme was built upon restrictive fiscal and monetary policies and was reinforced by the financial package (Exchange Stabilization Fund) assembled by the US financial authorities and multilateral organizations. The rescue package amounted to more than US$ 52 billion: $17.8 billion committed by the IMF, $20 billion by the United States government, $10 billion by the Bank for International Settlements, $3 billion by commercial banks and $1.5 billion by the Bank of Canada. It is worth mentioning, however, that in 1995 Mexico's drawings amounted to only $24.9 billion. A solvent government might still face liquidity problems that limit its ability to service its debt. For instance, an overly pessimistic view about the future of the economy might lead lenders to curtail the amount of financing temporarily even if the country is in fact solvent. Eventually, liquidity problems might escalate, negatively affecting the government's
access to international capital markets. At this particular stage, the distinction between liquidity and solvency problems for a country is .At the same time; the private pension fund system has continued to grow, making long-term resources more widely available. Today, Mexico's foreign

debt amortization schedule is light and well distributed over time. The overall debt burden, including domestic and external debt, diminished from levels above 450/0 of GDP in 1990 to approximately 280/0 in 1998. This trend is thought to have continued in 1999.The country's solvency and liquidity indicators compare favorably to those of other countries: external debt as a share of GDP amounted to 170/0 in early 1999, while the ratio of total exports to external debt was 1.7. An example of Mexico's strategy to ensure external financing when conditions in international capital markets turn adverse is the credit line secured with international financial institutions in November 1997.

1.6 Burden of External Dept In India

IT IS A source of some comfort that India's external debt continues to be at a stable level. According to the latest status paper prepared by the Union Finance Ministry, the stock of foreign debt stood at $98.4 billion at the end of December 2001. After a substantial increase of $16 billion between 1991 and 1995, partly on account of fresh loans and partly on account of exchange rate movements, the total debt has fluctuated between $93 billion and $99 billion since 1995. Going by a number of indicators, India's external debt situation is far better today than it was during the balance of payments (Bop) crisis of 1991. While the absolute size of foreign debt is important, more relevant is the weight this debt imposes on the economy. And, on that count, the burden has become lighter and lighter, even as the stock of outstanding has remained more or less constant. Annual repayments of loans and interest as a percentage of current receipts — the debt service ratio, which was as high as 35 per cent in 1990-91, has fallen to 13 per cent today. Debt as a percentage of the gross domestic product has nearly halved since the early 1990s. And the short-term debt to GDP ratio, which crossed 10 per cent in 1990-91 and precipitated the Bop crisis of that year, has been held under 3 per cent. Overall, India is now classified by the World Bank as a "less" indebted country, which is two rungs below the extreme category of "severely" indebted countries, which is where Brazil, Argentina and Indonesia now belong. In absolute terms as well, India's position has improved globally. In the mid-1990s, India was the third largest debtor in the world; today it is ranked ninth. All this has taken place in spite of the fact that new loans are increasingly being raised on commercial rather than concessional terms, as was the practice for decades.

1.7 External Debt Management Policy

India's Debt-GDP ratio which shows the magnitude of external debt to domestic output had declined from 38.7 % at the end of March 1992 to 22.3% at end March 2001.Similarly the debt service ratio that measures the ability to serve debt obligations has declined form 35.3% of current receipts in 1990-91 to 16.3% in 2000-01.This improvement in external debt should be attributed both to a cautious policy on foreign borrowings (which includes annual caps on commercial loans which would not have been possible if the rupee was fully convertible) and to the steady growth in current receipts in the Bop. There are, however, enough areas of concern, which should prevent complacency and persuade the Government to go slow on capital account convertibility. The first is that while the short-term debt to GDP ratio was only 2.8 per cent at the end of 2001, the more accurate measure of immediate repayments— total debt of a residual maturity of one year — was 9 per cent of GDP in December 2001. This is still not a very heavy burden, but it is not something to be taken lightly. The second concern should be that the estimate of debt servicing in the years ahead (based on past borrowings) shows that there are going to be two major humps round the corner. In 2003-04 and 2005-06, repayments of the expensive Resurgent India Bonds and India Millennium Deposits fall due. Debt service in both years will then cross $12 billion. This will be the largest since 1995-96, though the Government hopes that not all the repayments will be repatriated. The third concern should be the impact of the Government's decision to make even the existing non-repatriable bank deposits by non-resident

Indians fully payable in foreign exchange. As a consequence, two such schemes were discontinued last April and outstandings transferred to repatriable accounts where they will be held till maturity. The stock of deposits in one of these schemes was itself over $7 billion. This means that if these deposits are taken out of the country when they mature they will add to India's debt service burden. And if they are renewed they will add substantially to India's external debt burden. Either way, the Government's decision is going to have a negative impact on the Bop.

1.8 Problems Of External Debt Management In India

Borrowing costs are not limited to interest costs. First, there is the dependency syndrome, which leads to the development of constituencies at the various levels of government to keep the borrowing momentum in full swing, actively supported by the multilateral development agencies. Second, there is an element of uncertainty in regard to whether the loans will be available when most needed, with the uncertainty increasing in the event of any demonstration of national self-reliance in area unacceptable to the stockholders of the lending agencies. Third, neither the civil servants negotiating the loans nor their political bosses have a direct responsibility for loan repayment, with the result that there is bound to be a relatively high degree of laxity in ensuring the best and most productive use of the borrowed funds. Fourth, there is hardly any evidence to indicate that countries with heavy indebtedness really can ever develop to such an extent that they will be free from such indebtedness.

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