Managing foreign debt and liquidity: India's experience

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Introduction

This paper describes in successive sections: the policy governing cross-border capital flows; the size and composition of capital flows with special reference to debt; tools of management of capital flows; the framework for management of external debt; the approach to short-term debt; the policies governing reserves and the exchange rate; the crisis avoidance strategies adopted; and the moves towards transparency in reporting debt and foreign exchange reserves.

Policy governing cross-border flows

India, after independence, opted for a model of development characterised by what was then perceived as self-reliance. Hence, till the early 1980s, external financing was confined to external assistance through multilateral and bilateral sources, mostly on concessional terms to or through government. In the 1980s, global developments, particularly the perceptible decline in the availability of official concessional flows in relation to the external financing needs of developing countries, changed the external sector situation at a time when India was initiating liberalisation. The compulsory repayments to the IMF during the late 1980s (of the Extended Fund Facility withdrawals in the early 1980s) added to the problems. Hence, recourse to external debt on commercial terms became inevitable. In addition to institutional sources (such as export-import agencies), syndicated loans and bonds, and deposits from non-resident Indians, were accessed. These had to be supplemented in the late 1980s with significantly large recourse to short-term facilities including, in particular, short-term non-resident deposits. Most of these liabilities were on account of government or government-owned enterprises or government-owned financial institutions.

The onset of the 1990s, however, saw the impact of the Gulf crisis on India. Combined with the large fiscal deficits of the 1980s and political uncertainties, this resulted in a drying-up of commercial sources of financing and in what could be described as a severe liquidity crisis in the balance of payments. Another global dimension that affected India's management of the balance of payments during this period was the serious disruption of trade with the erstwhile USSR on top of worrisome recessionary tendencies in the industrialised countries and loss of export markets in West Asia. The crisis was overcome by a series of stringent measures with an overriding objective of honouring all external obligations, and not rescheduling or prioritising any external payment obligation.

Along with stabilisation, a reform process was undertaken in many sectors. The broad approach to reform in the external sector was laid out in the *Report of the High Level Committee on Balance of Payments* chaired by Dr C Rangarajan. The Committee recommended the introduction of a market-determined exchange rate regime while emphasising the need to contain the current account deficit. It recommended, inter alia: liberalisation of current account transactions leading to current account convertibility; a compositional shift in capital flows away from debt to non-debt creating flows; strict regulation of external commercial borrowings, especially short-term debt; discouraging volatile elements of flows from non-resident Indians; gradual liberalisation of outflows; and dissociation of government from the intermediation of external assistance. The Committee thought that the traditional practice of viewing the level of desirable reserves as a percentage of imports was now inadequate. It recommended that due attention should be paid to the payment obligations in addition to the level of imports while monitoring reserves. The policy framework for the external sector based on the Committee's Report was implemented along with policy changes in trade, industrial and financial sectors.

In brief, reform in the external sector was meshed with reform in other related sectors. Within the external sector reform, capital flows were managed keeping in view the needs of efficiency and stability. There was a fairly smooth transition from an administered exchange rate system to a market-determined exchange rate. In this process, the Reserve Bank of India (RBI) attempts to ensure that volatility and

speculative elements in foreign exchange markets are curbed through both direct and indirect measures.

Size and composition of capital flows

Since the gradual capital account liberalisation was initiated in 1991, capital flows have been in excess of the current account deficit except in 1992/93 and 1995/96, thus adding to reserves. It is interesting to note that while the stock of external debt increased by US$ 8 billion between 1991/92 and 1997/98, foreign currency assets increased by US$ 20 billion, thus implying that much of the reserves was accumulated through increasing non-debt creating flows. However, in 1998/99, external debt increased by $4.1 billion whereas foreign currency assets increased by $3.5 billion. During 1999/2000 (up to December 1999), external debt increased by $1.3 billion while foreign currency assets increased by $2.5 billion.

As regards the composition of capital flows, net private flows, which averaged about half of total net capital flows in the 1980s, accounted for nearly the whole of the net capital flows between 1997/98 and 1999/2000. Foreign direct investment (FDI) was the most significant vehicle of private capital. It increased from an average of $80 million, (around 1% of net capital flows) in the 1980s to an average of $2.7 billion (27% of net capital flows) during the period 1996/97 to 1999/2000. Total portfolio investment flows on account of foreign institutional investors, global depositary receipts and others averaged around $2.6 billion during 1995/96 to 1997/98 despite a sharp drop in flows during 1997/98 to $1.8 billion from $3.3 billion in 1996/97. Portfolio flows turned slightly negative during 1998/99 reflecting uncertainties in both the domestic and the international environment. However, such flows recovered during 1999/2000, with net inflows of $3.0 billion.

Management of capital flows

Based on the policy framework and the projected financing requirement for each year, management of the capital account is operationalised through procedures for FDI, portfolio investment, external commercial

borrowings, non-resident Indian (NRI) deposits, and outflows. The broad approach to targeting FDI has been to permit such inflows on the automatic route for all categories unless specified otherwise. Portfolio investments are restricted to selected players, viz, foreign institutional investors, NRIs and Overseas Corporate Bodies predominantly owned by NRIs and wealthy individuals. Indian corporates are allowed to issue global depositary receipts and American depositary receipts without prior approval subject to specified guidelines. External commercial borrowings are subject to case by case approval, based on the size and sector. In respect of NRI deposits, control over inflows is exercised through specification of interest rate ceilings for different maturities in respect of deposits in selected schemes. More generally, variable reserve requirements are stipulated for encouraging or discouraging such flows. As regards external assistance, both bilateral and multilateral flows are administered by the Indian government.

In respect of capital outflows related to inflows (ie principal, interest, dividend, profit and sale proceeds) there are no restrictions at all. In respect of capital outflows from residents, the approach has been to facilitate direct overseas investment through joint ventures and wholly owned subsidiaries and provision of financial support to promote exports, especially project exports from India. There are dual routes, namely automatic and case by case and there is an aggregate annual ceiling for such approvals.

The general thrust is to liberalise gradually by giving adequate notice, and opportunity to adjust, to the market participants. Liberalisation measures are also timed to take cognisance of the state of financial markets, especially foreign exchange markets, and the progress of reform in other sectors of economy.

Management of external debt

If a precise statement on our policy towards external commercial borrowings (ECBs) were made, it would read as follows:

> "Consistent with the overriding norms of prudent debt management, the Government's policy approach towards commercial borrowing essentially reflects the finance needs of the country in terms of a sustainable current account deficit and the availability and relative

costs of various forms of external capital. Prescribing annual ceilings for commercial borrowings and attaching priority in approvals to sectors such as infrastructure (power, telecommunications, transportation, railways, etc), capital goods imports, and exports have constituted the basic approach towards policies relating to ECBs. Requiring prior authorisation for foreign borrowing is a prudent way of protecting a country's long-term balance of payments position."

India's short-term debt (less than one year of maturity) has remained less than 10% of total debt. The maturity structure of new commitments to India indicates that for official loans the average maturity fell from about 41 years in 1980/81 to 26 years in 1998/99 and for private commercial loans, the decline was from about 16 years in 1990/91 to seven years in 1998/99. Compared with other debtor developing economies, the term structure of the debt flows to India has also been by and large longer. For example, average maturity of new commitments to Mexico was nine years for official credit and seven years for private credit.

The policy dimension relating to an appropriate maturity structure, which was earlier viewed as a micro decision, is now being recognised as a macro aspect and a stability issue. Elongation of the average maturity ensures a sort of private sector burden-sharing in times of crisis. It is important to recognise that the insurance embedded in long-term debt often outweighs the cost. These issues have direct relevance to corporations' access to external funds, in terms of both cost and the period of borrowings. The cost of borrowings may increase on account of longer maturities, but they will have the comfort of stable flows. In times of crisis, the costs of disruption on account of destabilising flows may far exceed the cost of raising longer-term debt.

There are questions about how the policymakers could promote or ensure an optimal maturity structure. There can be several views on what is an optimal maturity. There is one influential view that the average maturity of a country's external liabilities should exceed a certain threshold, say three years.

In India, emphasis is laid not only on the cost and size of debt, but also on the maturity. The desired maturity profile is taken into account in policy articulation and clearance of individual cases. The preferred average maturity of our ECBs is five years or more. A liberal view is taken if maturity exceeds eight years. At the same time, in according

individual clearances, bunching of repayment obligations is avoided. More recently, it has been decided, in principle, to allow ECBs of up to $50 million without prior approval. Basically, considerations of the size, cost and maturity are embedded in the clearance mechanism for ECBs.

Approach to short-term debt

Among short-term liabilities, debt constitutes a contractual obligation and is thus on a different footing to the others. The link between short-term debt and reserves has come to the fore in recent deliberations. Our view is that there is a cost to building up reserves through large debt flows since the cost of debt would generally be higher than the return on reserves. However, not all short-term flows are bad and some short-term finance is essential to finance transactions. In fact, we recognise that trade related short-term credit is not as volatile as non-trade related credit. Short-term credit is controlled through specific authorisations restricted to trade related credits within annual ceilings as well as an overall cap on outstandings.

The share of short-term debt has remained low. Compared with other developing countries, India has a relatively low dependence on external financing of short-term maturity. India's short-term debt was 10% of total debt in 1990, compared with an average of 18% across all developing countries. By December 1999 the figure had come down to 5% for India as compared with about 17% for developing countries as a whole.

Our reserve management strategy does take into consideration the size of short-term debt while deciding the adequacy of foreign exchange reserves. At the end of December 1999, the ratio of short-term debt to the level of reserves stood at around 13%.

Policies on reserves

In international fora, there has been a continuous but inconclusive discussion on the optimum level of reserves. Traditionally, however, the adequacy of reserves has been mainly linked to import requirements.

The RBI Annual Report of 1996/97 stated that "in the context of the changing interface with the external sector and the importance of the capital account, reserve adequacy needs to be evaluated in terms of indicators other than conventional norms. Thus, even if exchange market developments accentuate the leads and lags in external receipts and payments the reserves should be adequate to withstand both cyclical and unanticipated shocks. Furthermore, in the context of fluctuating capital flows, it is useful to assess the level of reserves in terms of the volume of short-term debt which can be covered by the reserves."

In 1997/98, the RBI Annual Report reiterated that "from the standpoint of achieving the goal of ensuring orderly conditions in the foreign exchange market and also to deal with situations arising on account of unanticipated and sudden reversals of capital flows, a level of reserve assets that could be considered as adequate needs to take into consideration a host of factors such as the cover for sufficient months of current payments, the stock of short-term and volatile external liabilities, shift in the pattern of leads and lags in payments/receipts during exchange market uncertainties along with the conventional norm of cover for sufficient months of imports."

India's foreign exchange reserves (comprising foreign currency assets and gold held by the RBI and Special Drawing Rights held by the government) increased for the fourth successive year during 1999/2000. The reserves increased by US$5.5 billion from $32.5 billion at end-March 1999 to $38.0 billion at end-March 2000. This followed increases of $4.7 billion during 1996/97, $2.9 billion during 1997/98 and $3.1 billion during 1998/99.

The $35 billion in gross foreign exchange reserves at end-1999 compared with outstanding short-term debt of about $5 billion. Cumulative net inflows of about $9 billion under portfolio investment by foreign institutional investors and cumulative issuance of global depositary receipts of about $7 billion up to December 1999, contributed to the build-up of reserves. Net of outstanding forward liabilities, the RBI's foreign exchange reserves, at about $37 billion (end-March 2000), were equivalent to eight months' imports and adequate to deal with any external imbalances arising on account of fluctuations in capital flows.

It is sometimes argued that we should not increase our borrowings when there is a build-up of foreign exchange reserves, since the return

on reserves is less than the cost of debt. But it must be noted that the level of reserves satisfies the need for liquidity, offers insulation against unforeseen shocks and acts as a source of comfort to foreign investors. The cost at which ECB is raised has country and other credit risk built into it, which is influenced by a host of factors, including the level of reserves. The essence of reserves management being safety and liquidity, all the investments made thereof are of highest credit quality and excellent liquidity and are usually short-term. Hence, the return on reserves and the cost of borrowing are not strictly comparable, though they need to be considered relevant if a borrowing is meant merely to shore up the reserves. Reserves, by themselves, should not, therefore, influence the desirable level of external borrowing. In fact, a comfortable level of reserves could help lower spreads on ECBs, and in that sense they are complementary rather than substitutable.

Besides the size of reserves, the quality of reserves also assumes importance. Unencumbered reserve assets must be available to the authorities at any point in time for fulfilling various objectives assigned to reserves. In India, the only encumberance is forward sales net of purchases. The RBI's accumulated forward liabilities, which were only $40 million in August 1997, rose to a peak of $3.2 billion (13% of the corresponding foreign currency assets) by January 1998 and then declined to $1.6 billion by June 1998. Forward liabilities stood well below $1 billion as at end-April 2000. As a matter of prudent management of external liabilities, the Reserve Bank's policy is to keep forward liabilities at a relatively low level, say less than 10% of gross foreign currency assets. Also, any bunching of such forward liabilities is avoided by deliberately spreading them predominantly over six months. Currently, there is also an inclination to ensure some minimal presence of the RBI in forward markets, say, at 2 to 3% of foreign currency assets.

Reserves and the exchange rate

The exchange rate is determined by the market, ie forces of demand and supply. The objectives and purposes of exchange rate management are to ensure that economic fundamentals are reflected in the external value of the rupee as evidenced by a sustainable current account deficit. Subject

to this general objective, the conduct of exchange rate policy is guided by three major purposes:

- to reduce excess volatility in exchange rates, while ensuring that the movements are orderly and calibrated.
- to help maintain an adequate level of foreign exchange reserves; and,
- to help eliminate market constraints with a view to the development of a healthy foreign exchange market.

As a general rule, foreign currency transactions take place to finance defined underlying transactions supported by documentation. Genuine hedging of exposures as well as some flexibility in dynamically reducing the cost of hedging is allowed. Basically, the policy is aimed at preventing destabilising speculation in the market while facilitating foreign exchange transactions at market rates for all permissible purposes.

The RBI makes sales and purchases of foreign currency, basically to even out lumpy demand or supply in the thin foreign exchange market; large lumpiness in demand is mainly on account of oil imports and external debt servicing on Government account. Such sales and purchases are not governed by a predetermined target or band around the exchange rate.

Crisis avoidance

It would not be appropriate to conclude that managing capital flows on the above lines, however efficient, ensures that there is total stability in capital flows. In fact, even with a managed capital account, we had to contend with occasional surges in capital flows between 1993 and 1997. In general, the short-term response has taken a number of forms, viz, raising of reserve requirements, reviewing the pace of removal of restrictions on capital inflows, relaxation of end-use specifications, liberalisation of capital outflows, partial sterilisation through open market operations, and deepening the foreign exchange market by routing an increased volume of transactions through the market.

The prolonged stability in the exchange rate of the rupee from March 1993 came under stress in the second half of 1995/96. In response to the upheavals, the RBI intervened in the market to signal that the fundamentals were in place and to ensure that movements in the exchange rate were orderly and calibrated. The pressures intensified

towards the end of January 1996 and the first week of February 1996. The RBI undertook measures to encourage faster realisation of export proceeds and to prevent an acceleration of import payments. The interest rate surcharge on import finance was raised, the scheme of post-shipment export credit denominated in foreign currency was scrapped and the RBI continued to intervene actively in the spot, forward and swap/money markets.

During periods of undue turbulence during the Asian crisis, exchange market intervention was supported by monetary policy action to withdraw liquidity. The year 1997/98 and the first quarter of 1998/99 posed severe challenges in exchange rate management in the face of the threat of external contagion and other uncertainties. Distinct phases of exchange rate movements and RBI responses can be identified. During April to August 1997, excess supply conditions prevailed in the market and the RBI undertook large net purchases of foreign currency. From September 1997 to mid-January 1998, acute exchange market pressure was staved off through the sale of foreign currency, coupled with administrative and monetary policy measures. Mid-January to April 1998 marked the return of stability and enabled rolling-back of the tight monetary measures introduced in January 1998.

When the foreign exchange market was characterised by considerable uncertainties in May–June 1998, several measures were announced by the RBI in June 1998 to reverse the destabilising sentiment in the market. Important amongst these measures were:

- the Reserve Bank's readiness to sell foreign exchange to meet temporary demand-supply mismatches;
- allowing the facility of forward cover to foreign institutional investors;
- allowing domestic financial institutions, with the Reserve Bank's prior approval, to buy back their own debt paper or other Indian paper from international markets;
- allowing banks acting on behalf of the foreign institutional investors to approach the RBI for direct purchase of foreign exchange; and
- advising banks to charge a spread of not more than 1.5 percentage points (previously 2–2.5) above Libor on export credit in foreign currency.

The market responded positively to these measures, but in August 1998 there were fluctuations in the exchange rate in view of international developments. The RBI once again undertook monetary

measures, which included raising the repo rate and the cash reserve requirement of banks.

An extraordinary situation that arose in 1998/99 consequent upon imposition of sanctions and the issue of Resurgent India Bonds (RIBs) is an interesting example of the management of the capital account in such a situation. The RIBs were designed to compensate for the extraordinary events in 1998/99, which may have resulted in some shortfall in the normally expected level of capital inflows in relation to the current account deficit of less than 2% of GDP. Due to these sudden developments in 1998/99, a temporary disruption in normal capital flows, especially debt flows, was anticipated. Instead of dipping into currency reserves, which might have affected sentiment adversely, or cutting the current account deficit through drastic import cuts, which would have affected real economic activity, the alternative was to enhance debt flows at the least possible cost.

During May 2000, the RBI undertook a series of measures in view of the prevailing uncertainty in the foreign exchange market. Important measures taken were:

- an interest rate surcharge of 50%, on a temporary basis, of the lending rate on import finance on all non-essential imports;
- meeting requirements of crude oil imports by the publicly owned Indian Oil Corporation and government debt service payments partly or fully by the RBI directly;
- the RBI would continue to meet temporary demand-supply imbalances;
- a minimum interest rate of 25% on overdue export bills;
- it was reiterated that the banks acting on behalf of foreign institutional investors are free to approach the Reserve Bank to procure foreign exchange. The banks were also advised to enter into transactions in the foreign exchange market only on the basis of genuine requirements.

Thus, the operations in the foreign exchange market have combined, as the situation warranted, sterilisation by way of open market operation, management of liquidity through repos, change in reserve requirements, signalling through interest rate changes (ie bank rate), levy of import surcharge and other measures. Such a coordinated response was demonstrated by the RBI during bouts of large capital flows as well as moderation in such inflows. Through close monitoring of domestic and

international developments, and timely as well as effective monetary and administrative measures, India was able to ward off the threat of contagion and mitigate the potential adverse effects of domestic developments such as the protracted border tension with Pakistan over Kargil.

Transparency

The issue of clarity is really an issue of defining properly categories or components of external debt, collecting data in an internationally comparable form and effective monitoring. Above all, the issue of transparency relates to clearly explaining the status of external debt.

The total external debt of India is compiled and published by the Ministry of Finance and the RBI at different frequencies. The Ministry publishes data annually in the *Status Report* and in the *Economic Survey*, which are public documents. The RBI publishes data in its *Annual Report* and the annual *Report on Currency and Finance*.

A Technical Group on External Debt (May 1998) has identified the areas needing further attention in regard to external debt data. These include presentation of external debt data on both original and residual maturity basis for some time before a final shift to residual maturity is made. Currently, a Monitoring Group on External Debt has been constituted to implement the recommendations of the Technical Group on External Debt and to work out the modalities for compiling and publishing quarterly data.

The RBI publishes daily data on exchange rates, forward premia, etc in the *Weekly Statistical Supplement* of the *RBI Bulletin* with a lag of one week. The movements in foreign exchange reserves of the RBI on a weekly basis are also furnished in the same publication. In addition, daily data on turnover in the foreign exchange market is published every week with a lag of about two weeks. Since July 1998, the RBI has published nominal and real effective exchange rate indices, based on trade with five and 36 countries, in the *RBI Bulletin*, with a lag of about one month. Way ahead of many developing and industrial country central banks, the RBI has been publishing the size of its gross intervention (purchase and sale) and its net forward liability position each month with a lag of only one month.