Financing of India's Balance of Payments: The Role of Debt Creating Flows

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Abstract

Existences of high cost of borrowing were one of main the reason for shifting of financing BoP away from debt flows in the post liberalization period. After a reduction in the share of debt flows between 2001-02 and 2003-04, it again bears an important part of net capital flows since 2003-04. Unlike in the past, these debt flows were productively used because the end use of ECB mainly concentrated on import of capital goods, project purpose and modernisation rather than used for loan refinancing, working capital and rupee expenditure.

1 Introduction

Debt creating flows were increasingly used for financing BoP in India up to the liberalization. Along with official debt flows, private debt such as Non Resident Indian (NRI) deposit, External Commercial Borrowings (ECB), short term credits were prominent part of the net capital flows from the starting of 1980's. But in post liberalization period nature net capital flows shifted to non debt flows and along with that, compositional shift happened within the debt flows from official to private debt flows. However, in the recent period, particularly from 2003-04 witnessed an increase in the private debt flows to India and in turn caused an increase the share of debt flows in the net capital flows between 2003-04 and 2007-08.

The main objective of the paper is to understand the role of debt flows for financing BoP during the liberalisation period. Paper is organized into seven sections: - Section 2 provide an overview of debt flows in liberalisation period. Section 3 counter factually analyse the years of India's dependence of debt flows for financing BoP. Sections 4 discuss the resurgence of debt flows in post 2002-03 periods. Section 5 compares the cost of external borrowing *vis-a-vis* domestic cost of borrowing and finally section 6 concludes main findings.

2 Overview of debt flows in liberalisation period

External assistance, External commercial borrowings (ECB), Trade credit and non repartiable component of Non resident deposit (NRI) constitute major portion of debt flows to India. Broadly, debt capital flows to India could be divided into three phases. First phase is the period from 1947 to 1980, second phase is 1980 to 1990 and third phase 1991 onwards. First phase is characterised as the multilateral and bilateral concessional loans were used as the sole source of financing BoP in India. During the second phase, India forced to attract costlier form of private debt flows such as ECB, short term debt and NRI deposit for financing BoP. This was mainly due to the shortages of official debt flows in relation to the huge current account deficit buildup in those periods (Reddy, 2006b). Third phase started from 1991 and marked by two changes, firstly the composition of debt flows shifted away from official to private debt[1] and secondly the focus of BoP financing shifted from debt to non debt flows. Share of debt flows was high at 83.3 % of net capital flows in 1990-91 (See Table 1). Since then, it is declined to -6.6% in 2003-04. But a slight resurgence of debt flows occurred thereafter. Between 2004-05 and 2007-08 share of debt flows were average at 44% of net capital flows, out of which external commercial borrowing and short term credit are the reason for increase in the share of debt flows. Concerned increase in the debt flows during the post 2003-04 periods would have significant effect on BoP, particularly in current account and it conditioned by cost of borrowing of these debts

At a disaggregated level, share of external assistance declined from 31.2% of net capital flows in 1990-91 to incredibly low at 2% in 2007-08. On the other hand, in the recent period India has started extending assistance to other countries mainly in the form of grant and loan. The major beneficiaries of the assistance were Bhutan, Nepal and Srilanka and Pakistan (Mohan, 2008). As a result of BoP crisis, flow of commercial borrowing indicated a slow down, thereafter it raised significantly in the latter half of 1990 and it constitute around 30% of net capital flows to India in those periods. Towards the late 1990's and early 2000's the demand for ECB remains low due to host of factors such as global economic slowdown, lower domestic demand. The year 2003-04 onwards marked resumption in the flows of ECB to India. Net inflows under ECB increased from $ 5194 in 2004-05 to exceptionally high at $ 22,633 million in 2007-08 and again it got reduced to $ 8158 in 2008-09 and it mainly due to the effect of global economic crisis. Short term credit to India is also high in the recent period and it increased immensely from 2003-04 onwards. In 2003-04, short term credit was very low at $ 970 million. Since then, it is increasing and reaches very high at $ 17,183 million in 2007-08

[1] Details are there in the annexure 1

Except few years, the flows of NRI deposit have been stable during the last two decades and it manifests the result of conscious policy followed by the Reserve bank of India. However, in the pre reform period policy initiative aimed at attracting nonresident deposit by offering a number of incentives including exchange guarantee and a higher rate of interest. Since 1991, such deposit has been streamlined by withdrawing the scheme with exchange guarantee, eliminating short term components in a phase to phase manner and the maturity structure of the NRI deposit also reversed to encourage long term deposit. NRI deposit with maturity less than one year was completely eliminated since April 2003 (Ministry of Finance, 2008).

Table 1: Share of Debt flows in the Total Net Capital Inflows to India

	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Net capital flows ($ millions)	**7056**	**3915**	**3876**	**8894**	**8502**	**4089**	**12007**	**9844**	**8437**	**10444**	**8840**	**8551**	**10840**	**16736**	**28022**	**25470**	**45203**	**107993**	**9146**
of which (%)																			
1) Non Debt Creating flows	**1.5**	**3.4**	**14.4**	**47.6**	**56.5**	**117.5**	**51.3**	**54.8**	**28.6**	**49.7**	**56.6**	**95.2**	**55.5**	**93.7**	**54.6**	**84.0**	**65.8**	**58.9**	**231.0**
2) Debt creating flows	**83.3**	**77.4**	**39.9**	**22.1**	**25.0**	**57.7**	**61.7**	**52.4**	**54.2**	**23.3**	**69.3**	**12.4**	**-12.3**	**-6.6**	**35.2**	**41.0**	**64.2**	**38.9**	**87.2**
a) External assistance	31	77	48	21	18	21	9	9	9	9	5	13	-29	-17	7	7	4	2	29
b) External Commercial Borrowings	32	37	-9	8	13	31	24	41	52	3	49	-19	-16	-17	19	10	36	21	89
c) Short term credits	15	-13	-28	-9	5	1	7	-1	-9	4	6	-9	9	8	14	15	15	16	-63
d)NRI deposit	22	7	52	14	2	27	28	11	11	15	26	32	27	22	-3	11	10	0	47
e) Rupee debt service	-17	-32	-23	-12	-12	-23	-6	-8	-10	-7	-7	-6	-4	-2	-1	-2	0	0	-1
3) Other capital	**15.2**	**19.3**	**45.8**	**31.1**	**17.1**	**-75.2**	**-13.0**	**-7.2**	**17.0**	**27.2**	**-25.9**	**-7.6**	**56.8**	**12.3**	**10.2**	**-25.0**	**-30.0**	**2.2**	**-218.2**
Total(1+2+3)	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100

Source: Compiled from Annual report of RBI (Various years)

Notes: Other capital includes leads and lags in export, banking capital excluding NRI deposit

3 Dependence on Debt Flows for Financing BoP in Liberalisation Period

Debt flows was the prominent source of financing BoP up to liberalisation period. Because of the buoyant availability of non debt flows, dependence of financing BoP with debt flows significantly reduced in the post liberalisation period. From 1990-91 onwards only five years India partially used the debt flows for financing BoP. In other words, India didn't have enough foreign investment for financing requirement. Out of the total five years, three years happened in the beginning period of liberalisation and financed around average of 90% of current account deficit with debt flows. Dependence of debt flows for financing BoP also necessitated in years such as 1997-98 and 1998-99. This dependence is mainly occurred because of low net inflows of foreign investment due Asian economic crisis. Due to the severity of low net foreign investment in 1998-99, 42% of current account deficit was financed with debt flows.

Table 2: Dependence on Debt Flows for Financing BoP in liberalisation[2]

Year	Financing BoP with Debt Flows (%)
1990-91	98.9
1991-92	88.7
1992-93	84.2
1997-98	2.7
1998-99	42.7

Source: Computed from RBI, Database on Indian Economy

Ever since 2000, India has never depended on debt flows for financing BoP. But in 2008-09 India didn't had enough capital flows to finance current account deficit due to global economic crisis and therefore 75% of current account deficit is financed with foreign exchange reserve. Therefore in 2008-09 neither the debt nor non debt flows saves the situation from using foreign exchange reserve to finance current account deficit.

[2] BoP can be financed with both debt and non debt flows. Dependence of debt flows for financing BoP means the gap of financing BoP with foreign investment and can be calculated by finding the percentage of net foreign investment in relation to current account deficit. If any year's value is less than 100, then there is a gap of financing with foreign investment.

4 Resurgence of Debt Flows to India

Substantial increase in the External Commercial Borrowings (ECB) and short-term credit was the main the reason for increase in the share of debt flows since 2003-04. For instance, 74% debt capital flows in 2007-08 was jointly contributed by short term credit and external commercial borrowings. Government policy of liberalizing the debt flows along with high interest rate difference in India relative to other nations are the reason for large increase in debt flows. The increase in ECB since 2003-04 can be attributed to the larger borrowings from international capital market by Indian corporate sector encouraged by the persistence of interest rate wedge between domestic and international interest rates and it also reflect sustained domestic investment demand and import demand in India (Mohan,2008). London Inter Bank Offered Rate (LIBOR) used as a yardstick for world interest rate. Suppose if we take LIBOR rate as proxy for foreign interest rate and monthly yield rate of corporate debt paper as domestic interest rate shows not only an interest rate difference but concerned difference keeps on widening for the last few years (See Figure 1).

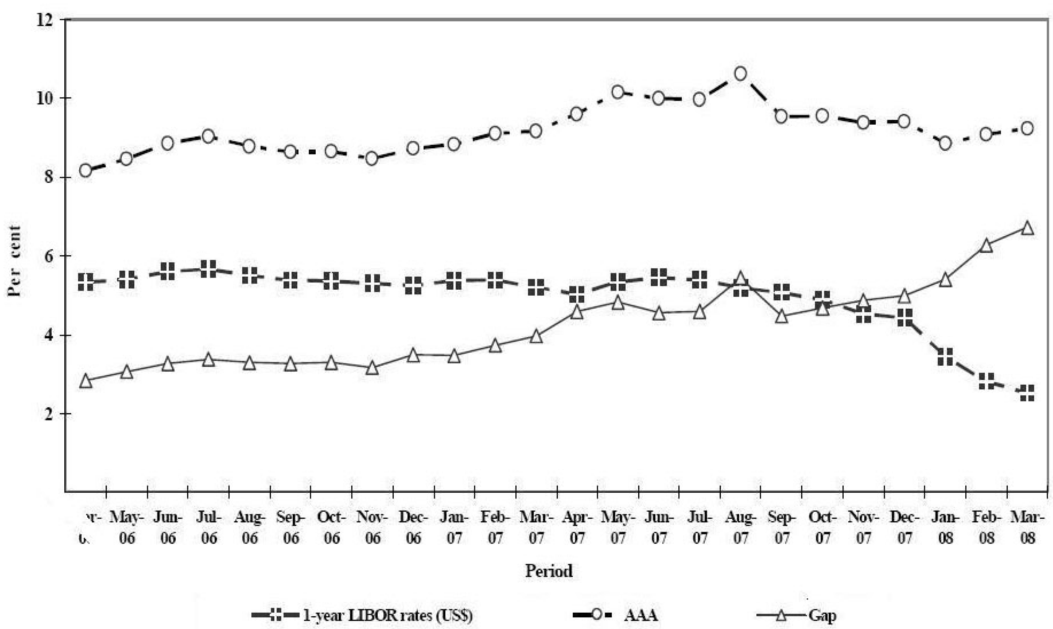

Figure 1: Monthly Yield Rate on Corporate Debt papers (with AAA rating) for five year maturity and LIBOR rate
Source: Ministry of Finance, (2008)

End use is an important consideration of debt and it would influence repayment of debt. Using RBI data on External commercial borrowings, we classified external commercial borrowing on the basis of end use and the data is available from 2004-05 onwards[3]. Classification on the basis of end use of external commercial borrowing shows that, for the past four years, ECB were being used for productive purpose such as import of capital goods, project purpose and modernisation. On the other hand share of loan refinancing, rupee expenditure and working capital propose has been quite low. Table 4.4 shows that, along with project purpose and modernisation, import of capital goods are the important end use of external commercial borrowings in India. For all types of external commercial borrowings, minimum maturity ceiling has been fixed at three year so far. However during the course of time, evidence shows that government had not compromise anything on maturity of external commercial borrowings for increasing its inflows because the last four years maturity of all the ECB contacted in each year is more than the average five years (See Table 3).

Table 3: Average Maturity of External Commercial Borrowings
(Values are in Years)

Year	Average Maturity
2004-05	5.95
2005-06	5.47
2006-07	5.81
2007-08	5.62
2008-09	6.53

Source: Calculated from RBI data on External Commercial Borrowings

Table 4: End use of External Commercial Borrowings
(Values are in percentage share of each to the total ECB)

Year	Import of capital goods	Project purpose	Modernisation	Rupee expenditure	Loan refinancing	Working capital	Other	Total
2004-05	30	21	19	11	4	1	14	100
2005-06	18	19	25	4	20	0	13	100
2006-07	20	30	25	13	2	0	9	100
2007-08	35	19	10	4	4	0	30	100
2008-09	53	15	5	13	4	0	9	100

[3] We classified on the basis of major end use of external commercial borrowing and other categories include all the other end use which are not classified here.

Source: Calculated from RBI data on External commercial borrowings

On the other hand, increase in the short term credit in the last few years is trade generated and resulted from higher level of imports in those years, particularly oil imports (Ministry of Finance, 2009). As a result of high trade credit, short term debt in India increased for the past few years. At present short term debt in India include, NRI deposit with one year or less than one year maturity, trade credit with less than six month maturity, Foreign Institutional Investment in government treasury bills and other Treasury bill investment by international institution and foreign central bank. Short term debt in India absolutely increased from $ 4.4 billion in 2004 to high at $ 49.3 billion in 2009, out of which trade credit roughly constitutes 90% increase in the short term debt[4] (Table 5). RBI closely monitors the stock of short-term debt on an ongoing basis. Because of the prudential regulation generally no rollover of short-term credit is allowed beyond six month. Besides foreign exchange reserve coverage of short term debt greatly improved in the liberalisation period. For instance, the ratio of short term debt to foreign exchange reserve down from 146% in 1990-91 to 19.9 % in 2008-09. Conscious approach could also see in the case of NRI deposit, in which short term element in NRI deposit eliminated in phase to phase manner and revising the maturity structure of the deposit to encourage long-term deposit. NRI deposits with maturity year or less completely eliminated since April 2003.

[4] The increase in the short term debt in the recent period could also attribute to the improvement in the coverage of short term debt. In the beginning of March 2005, coverage of short term debt has expanded to include all types of trade related credit with the maturity of six months to one year. Additional elements in the short term debt are namely, i) suppliers credit maturing in less than six months and ii) FII investment in treasury bills and other short term debt instruments having a maturity of year or less as a part of short term debt.

Table 5: Components of Short-term Debt in India

(Absolute values are given in US millions $, percentage share are given in brackets)

Year March end (1)	Short term debt (2)=(3+4+5+6)	NRI deposits (3)	Trade credit (4)	FII in Govt Treasury bills and other instruments (5)	Investment in treasury bills by foreign central bank and international institutions, etc (6)
2001	3628	957	2671(73.6)		
2004	4431	304	4127(93.1)		
2005	17723		16271(91.8)	1452	
2006	19539		19399(99.3)	140	
2007	28130		25979(92.4)	397	164
2008	46999		43162(91.8)	651	155
2009	49373		45975(93.1)	2065	105

Source: Ministry of Finance, (2009)

5 External Assistance to India and Interest Bearing Loans

External assistance has played significant role in the development process in India. However, unlike the past, now India has no longer reliant on external assistance for financing BoP. In donor wise, external assistance mainly composed of multilateral and bilateral assistance. In the recent period, International Development Association (IDA), International Bank for Reconstruction and Development (IBRD), Asian Development Bank (ADB) are the major donors of multilateral segment of external assistance where as Japan, United Kingdom (U.K), Germany, European Economic Community (EEC), United States of America (USA), Russian federation are main nations in which we have been receiving bilateral assistance (Ministry of finance, 2008b).

IDA, the soft loan affiliate of World Bank and carry lower rate of interest where as loan from IBRD and ADB are carrying market rate of interest therefore it is relatively costly. However borrowing from ADB and IBRD has been showing an increase in the recent period. The continuance of borrowing from ADB, IBRD assumes special importance from the possibility of India being kept out of IDA loans. IDA loans are extended only to low income countries. At present India though a low income country, is at the border line. Grant element component of assistance under multilateral agencies are low and it is very negligible for IBRD and ADB loans (See Annexure 2). On the other hand major part of bilateral assistance is getting from Japan and grant element part is low under this segment. In the recent period evidence shows that, even though the bilateral assistance from U.K, EEC and USA were lower, however, most of the assistance was received from these nations as grant. Grant element is also very higher for the bilateral assistance from Germany (See Annexure 3)

Table 6: Weighted Average Interest of External Borrowings from Different Sources

Source	2004-05	2005-06	2006-07	2007-08
ADB	3.76	4.49	6.28	6.85
IDA	0.87	0.79	0.82	0.8
IBRD	2.14	4.13	5.78	6.01
Russia	3.03	3.42	3.44	3.48
Germany	0.89	0.74	0.84	0.78
Japan	2.57	2.35	2.37	2.44
France	2.57	2.21	2.49	2.27
USA	2.88	2.89	2.92	3.1
Others	1.05	1.03	1.03	1.05

Source: Ministry of Finance, (2008b)

Weighted average interest rate for ADB and IBRD are not only very higher in the external assistance portfolio, but also the interest rate is increasing under the period of analysis (See Table 6). Moreover table 6 shows two things, firstly IDA loans found to be one of the low cost borrowing items in our external assistance portfolio. Secondly, cost of borrowing of bilateral assistance from Japan is very low as we compare with that of ADB and IBRD loans. Japan is the major bilateral donor to India and their weighted average interest rate is very low and follows more or less same interest rate throughout period of analysis. Crucial question here is why government has been increasingly borrowing high cost loans from ADB and IBRD.

5.1 Relative Benefit of Domestic Borrowing vis-à-vis External Borrowing

Loans from ABD and IBRD are carrying market rate of interest and therefore these are found to be high cost categories of loans in India's external debt portfolio. Though our external borrowing is composed of these high cost loans, but the total cost of external borrowing is still very low as we compare it with cost of domestic borrowing. This phenomenon is because of the existence of high interest rate in India relative to other nation; therefore cost of borrowing of from domestic very high in relation to external borrowings.

Table 7: Comparative Analysis of Debt Service Liability on External and Domestic Borrowings (Values are in Rs Crores)

Year	Total Outstanding of Internal borrowings[5]	Interest payment of Internal borrowings[6]	Weighted average Interest rate of Internal borrowings	Total outstanding of External borrowings	Interest payment of External borrowings	Weighted average Interest rate of External borrowings
1991-92	317714	17920	6.3	208724	8676	5.8
1992-93	359655	20418	6.4	275910	10657	5.1
1993-94	430623	25026	7.0	290743	11715	4.2
1994-95	487682	30923	7.2	310871	13137	4.5
1995-96	554983	35759	7.3	313525	14286	4.6
1996-97	621437	43759	7.9	331818	15719	5.0
1997-98	722962	48902	7.9	347606	16735	5.0
1998-99	834552	59030	8.2	407605	18852	5.4
1999-00	962592	70819	8.5	425800	19430	4.8
2000-01	1102596	78930	8.2	462902	20384	4.8
2001-02	1294862	86766	7.9	471401	20694	4.5
2002-03	1499589	99854	7.7	507734	17950	3.8
2003-04	1690554	103175	6.9	513027	20913	4.1
2004-05	1933544	113284	6.7	597468	13650	2.7
2005-06	2165902	109524	5.7	611563	23106	3.9
2006-07	2435880	125510	5.8	775871	24762	4.0
2007-08	2725395	144443	5.9	903704	26587	3.4
2008-09	3014441	162765	6.0	1055572	29929	3.3

Source: Calculated from RBI (2009), Ministry of Finance (2009)
Note: weighted interest rate of particular loan in year is nothing but the percentage share of interest amount paid with the total outstanding loan in the last year.

Table 7 correctly highlight existence of cost difference between domestic and external borrowing, out of which cost of external borrowing stood at very lower compared to the cost of domestic borrowings. For instance weighted average interest rate for

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[5] Total outstanding of internal borrowing consists of the total outstanding internal debt and other interest bearing liabilities. Internal debt consist of market loans and other medium and long term loans, treasury bills and special securities issued to national small saving fund where as other interest liabilities include insurance and pension fund, deposit of non Govt provident fund, reserve funds of commercial departments special securities to oil companies, FCI and others. From 2004-05 the provision for interest payment on borrowings under the market stabilization scheme (MSS), have been separately reflected in terms of MOU on MSS

[6] Interest payment of internal borrowings is calculated by subtracting interest payment of external borrowings from total interest payment

domestic borrowing was at 6% in 2008-09, but in the same years weighted average interest rate was only 3.3% for external borrowing. There was no much difference between the cost of borrowings of external and domestic borrowings in the beginning of liberalisation period, but since then cost of external borrowing dramatically declined where as domestic borrowing increasing very much in the observation period. Though cost of domestic borrowing has been declining in beginning period of liberalisation and it showed a large increase especially between 1998-99 and 2002-03. However, the post 2003 cost of domestic borrowing is declining, but as of now cost of domestic borrowing is very higher vis-à-vis external borrowings.

6 Conclusion

Existence of high cost of borrowing was one of main the reason for shifting in financing BoP away from debt flows. Even though the focus of BoP financing shifted away from debt flows however period from 1990-91 to 1999-2000, five years India partially relied on debt flows for financing BoP. After a reduction in the share of debt flows between 2001-02 and 2003-04, it again bears an important part of net capital flows since 2003-04.

Drastic increase in the short term credit and External Commercial Borrowings (ECB) are the reason for the large increase in the debt flows in the post 2003-04 periods. Unlike in the past, these debt flows were productively used because end use of ECB mainly concentrated on import of capital goods, project purpose and modernisation rather than used for loan refinancing, working capital and rupee expenditure. Increase in the short term credit is trade related and it is due to high import of Petroleum Oil Lubricant (POL) product in the last few years. Though there is a reduction in the total cost of borrowing of debt flows, however, some high cost loans are still existed in India's debt portfolio. ADB and IBRD loans are fall under these categories because these loans are carrying market rate of interest. Weighted average interest rates for these loans are increasing for the last few years. At the same time when we compare the total cost of external borrowing with domestic borrowing latter is higher than the former even with the presence of high cost loans like ADB and IBRD.

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Annexure

Annexure 1

Share of outstanding official and private creditor in the total debt outstanding
(Values are in percentage share of each category to total)

End- March	Official creditors	Private creditors
1998	58.1	41.9
1999	56	44
2000	56.2	43.8
2001	51.2	48.8
2002	51.8	48.2
2003	48.3	51.7
2004	45.2	54.8
2005	39.3	60.7
2006	37.3	62.7
2007	31.8	68.2
2008	27.8	72.2
2009	27.4	72.6

Source: Ministry of Finance, (2009)

Annexure 2: Multilateral Assistance Received from Major Donors

(Absolute values are in Rs crores, values in the parenthesis indicate the percentage share of loan and grant element)

Donor/ Years	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
IDA	4871 (99.53/0.43)	5782 (99.22/0.78)	4303 (9941/0.59)	4178 (99.37/0.63)	4632 (99.23/0.57)	5363 (99.81/0.19)	4306 (99.65/0.35)
IBRD	3376 (95.82/4.18)	3636 (98.01/1.99)	3250 (98.48/1.52)	4087 (98.67/1.32)	3725 (99.07/0.92)	4200 (99.23/0.77)	4439 (99.66/0.34)
ADB	2145 (100/0.0)	1914 (100/0.0)	2588 (100/0.0)	2745 (100/0.0)	2149 (100/0.0)	2682 (99.96/0.04)	4060 (97.37/2.63)
Total	10541 (97.80/2.20)	11530 (98.0/2.00)	10338 (96.87/3.13)	11138 (98.65/1.35)	10681 (98.08/1.92)	12466 (98.28/1.72)	13221 (96.15/3.84)

Source: Ministry of Finance, (2008)
Note: Total denotes Total Multilateral Assistance

Annexure 3: Bilateral Donors

(Absolute values are in crores, values in the parenthesis indicate the percentage share of loan and grant element)

Donor/ years	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Japan	2729.8 (99.4/0.6)	3728.9 (100/0)	3328.9 (99.7/0.3)	3277.7 (99.8/0.1)	2971.18 (98/2)	2710.36 (97.92/2.08)	2097.62 (98.28/1.72)
U.K	307.3 (0/100)	808.4 (0/100)	778.7 (0/100)	1279.94 (0/100)	1506.93 (0/100)	1371.94 (0/100)	1310.32 (0/100)
Germany	386.7 (82.5/17.5)	444.7 (65.9/34.1)	381.16 (50.83/49.17)	333.41 (59.21/40.79)	121.18 (14.87/85.12)	188.24 (18.25/81.75)	278.32 (36.48/63.52)
EEC	36.28 (0/100)	181.9 (0/100)	326.03 (0/100)	147.54 (0/100)	426.31 (0/100)	820.51 (0/100)	397.88(0/100)
USA	81.11 (0/100)	66.18 (0/100)	49.86 (0/100)	110.56 (0/100)	80.17(0/100)	52.66(0/100)	44.56 (0/100)
Russia	130.09 (100/0)	23.03 (100/0)	316.06 (100/0)	771.71 (100/0)	1194.82 (100/0)	1106.83 (100/0)	1404.41 (100/0)
Total	3866.18 (83.5/16.5)	5624.8 (72.4/27.6)	5399.46 (71.94/28.06)	6218.05 (68.97/31.03)	6446.38 (64.84/35.05)	6309.14 (60.52/39.48)	5531.26 (64.60/35.40)

Source: Ministry of Finance, (2008)
Note: Total denotes Total Bilateral Assistance