Growing worries about the economy of India

by Ramtanu Maitra and Susan Maitra

Inaugurating the Economic Editors Conference on June 7, Indian Finance Minister Madhu Dandavate suggested that a ceiling be imposed on government borrowing, both internal and external, under Article 292 of the Constitution. Article 292 empowers the Indian Parliament to set the limit on how much financial debt the country can carry without compromising national security.

"As yet, we are not caught in a debt trap," Dandavate stated. But the mere suggestion of Article 292 has serious implications, particularly in light of the Eighth Five-Year Plan scheduled to be launched this year. According to every available estimate, the new plan is going to be the most expensive ever. The re-drafted paper recently submitted by the Planning Commission puts the cost of the plan at close to $350 billion. All this money is to be mobilized and spent for economic development during the years 1990-94.

In addition to the unenviable task of mobilizing financial resources for the plan, policymakers are becoming increasingly concerned about India's growing internal and external debt. India's external debt, which is to be paid back in hard currency, has risen to more than $60 billion. Internal debt has zoomed to the equivalent of about $90 billion. The redeeming feature of internal debt, of course, is that it is to be paid back in rupees and can be rescheduled as and when government feels necessary. But under the circumstances, when interest payments to outstanding loans and debt repayments are eating up a large chunk of mobilized resources, the concern remains how India is going to finance the ambitious Eighth Five-Year Plan and what Article 292 will do, if imposed, to the plan size. Given the longstanding weaknesses in India's physical economy and a growing population, formulation and execution of the plan will have a distinct effect on the country's future economy.

External debt balloons during 1980s

During the 1980s, India's external debt rose dramatically (see **Table 1**). While a good part of the debt has accumulated over the years from receiving various loans, soft and hard, one distinct reason behind the fast growth of external debt is the annual trade deficit (see **Table 2**). Last year's trade deficit has now been estimated at $4.6 billion, a slight increase over the $4.4 billion incurred during 1988-89.

According to the government's 1989-90 Economic Survey, India's long-term and medium-term debt rose sharply from $21 billion in 1984-85 to $40.5 billion in 1988-89. According to the World Debt Tables (1988-89), the estimated long- and medium-term debt of India will reach $50 billion in 1990. A recent statement by the finance minister indicates that the World Debt Tables were on the mark.

The rest of India's external debt—now close to $14 billion—is in short-term commercial borrowings. A significant part of it is accounted for by deposits from non-resident Indians based abroad in the form of Foreign Currency Non-Resident (FCNR) accounts. FCNR accounts, which are in essence similar to indirect borrowings from international financial markets, since the interest offered on these deposits is market-related, rose from a meager $1.0 billion in 1985 to an estimated $10 billion in 1990. As analysts point out, the money deposited in the FCNR accounts can be troublesome since it does not have an automatic rollover and can be withdrawn prematurely if the depositor feels the conditions of safety, liquidity, and expected returns are not fulfilled. The balance of short-term debt—about $4 billion—was accrued by direct borrowing from the market and can be easily rolled over under prevailing trade practices.

Even though a large part of it is long- and medium-term,

TABLE 1
External debt mushrooms after mid-1980s
(billions of $ at present exchange rate)

Year	External debt	Debt service
1984-85	21	3.4
1990-91	64	6.6

TABLE 2
Worsening annual trade deficit added to debt burden
(billions of $ at present exchange rate).

Year	Amount
1980-81	3.4
1985-86	5.2
1989-90	4.6

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the growing external debt causes a heavy drain on the country's foreign exchange reserves for debt service. The debt service ratio shot up from 21.9 in 1985 to a high of 34 in 1988, and then dropped back to 29.2 in 1990. Total foreign exchange disbursement on this account has gone up from $3.4 billion in 1985 to $6.6 billion estimated for 1990, including the interest payments to the FCNR deposits.

A serious debate has now begun in India over the handling of the country's precious foreign exchange. On one side, ardent demands are made to increase exports and reduce imports. On the other, there is a growing chorus arguing that dependence on foreign loans be reduced and emphasis be placed instead on creating an economic climate suitable for attracting expanded foreign investment.

While much can be said about the necessity of enhancing India's future exports (see **Table 3**), it is also clearly recognized that future export growth cannot be seen in isolation. In fact, India's export growth prospects rely largely on the world economic situation. It is evident that the world economy is not headed for any sharp upturn in the near future. On the contrary, it would be suicidal for Indian officials to depend too heavily on the prospect of a booming export growth in order to deal with the debt burden.

In addition, the argument in support of curbing imports significantly has come under closer scrutiny recently. Petroleum oil and lubricants, unworked precious stones, capital goods, and chemical elements accounted for almost 60% of India's imports in 1988-89. No drop in rising petroleum consumption is expected in the coming decade, nor can any policy decision be taken on the assumption of a future large oil find. The other major import items are all essential ingredients for raising exports. Though some import substitution can be effected in the case of capital goods, these relatively lower-level technology import-substituted capital goods will not be able to produce products that are competitive in international markets. The nominal import liberalization instituted in 1985-86, a whipping boy of India's left intellectuals, did increase import intensity in some sectors—but it is a fact that such import-intensification has led directly to rapid expansion of exports from those sectors. As one economist put it: "Import substitution over the years has, in fact, led us into export substitution"—and this has created the balance of payments crisis at hand.

Some lobby for foreign investment

While the debate over export-import policy shows that it would be well-nigh impossible to turn back on "liberalization," another lobby in India is strongly pushing foreign investment as a preferred source of needed foreign exchange. India has not been able to attract foreign investment due to the myriad of industrial regulations and licensing policies and the unwillingness to part with more than 40% of equity to foreign investors. As a result, there is only $1.6 billion of foreign investment in India, less than 0.2% of the world's share.

TABLE 3

Leap in exports cannot be sustained

(billions of $ at present exchange rate)

Year	Amount
1980-81	4.0
1985-86	6.4
1989-90	16.3

According to some, all this can and should be changed. The argument in favor of attracting foreign investment is simple and powerful. First, foreign investment is better than taking loans. Loans have to be paid back even if the borrowed money fails to generate any surplus. In the case of foreign investment, which is more like "risk ventures," investors will only be taking back hard currency annually in the form of dividends, which could be around 4-5% of the capital invested—and that too, only if the investment succeeds in producing a net profit. Second, foreign exchange that comes in in the form of investment is not subjected to the vagaries of interest rate fluctuations. This is a real factor since the Ibero-American countries were literally looted by the foreign bankers through the arbitrary process of interest rate hiking.

The opponents of foreign investment—an unholy alliance of leftist intellectuals and Indian manufacturers who benefitted enormously from selling shoddy products to captive Indian consumers—complain that foreign investors dump old technologies and use patent laws and other excuses to deny requests for the most advanced technologies in the entire range of industries. Protagonists have a ready answer: Government insistence on a high export component for foreign investors will ensure that they install the most efficient technologies. The other concern, that foreign investors will "take over" the country if the door is opened, no longer cuts the mustard in light of the country's size and strength.

The issue remains unresolved. It is evident that foreign investors will not find India attractive for investment unless a number of measures—including increasing the equity limit for foreign investors from 40 to 50%, amending the Foreign Exchange Regulation Act which presently directs foreign investors to the core sectors of the economy to secure more equity, making changes in export-import policy, deregulation, and de-licensing of the industrial sector, and a significant improvement of the physical infrastructure—are undertaken. There is no visible sign yet that the government is ready to deal with these ticklish issues.

India, of course, can go to the International Monetary Fund for yet another loan and/or continue to lobby intensely for a greater share at the World Bank's soft loan window, the IDA. While the latter option is getting dimmer day by day, a loan from the IMF is an option that the government is

surely toying with. At the IMF finance ministers meeting in Washington in May, Finance Minister Dandavate denied that India had already applied for a loan from the IMF. But, he added, curiously, "We always would like to cross the bridge when we reach it." There are many who point out that given the size of the nation's internal and external debt and a perpetual balance of payments problem, the IMF will not simply agree to India's request for a loan, but will make sure that rigid conditionalities are imposed to initiate the so-called structural adjustment of the economy. Such a prescription would sound the political death-knell for the coalition government in New Delhi.

Internal debt growing even faster

India's internal debt has also grown by leaps and bounds between 1985 and 1990 (see **Table 4**). In 1985, total internal debt was about $42 billion. In 1990-91, the amount is expected to rise to about $88 billion—a more than twofold rise. Of these loans, the greater interest-bearing components like long-term borrowings from the market, 15-year annuity certificates, and compensation bonds, dominate. Short-term borrowings consisting of Treasury bills issued to the Reserve Bank of India, state governments, commercial bankers, and other parties, account for less than 30% of total debt outstanding. As a result, a self-expanding debt spiral has been created: In 1990, more than 50% of the increase in internal borrowing is being used to repay interest on accumulated debt.

A number of suggestions have been made to deal with this. The primary ones include: reduction of government employment, increased tax revenue collection, and improvement in the performance of public sector enterprises. While tax revenue collection can be made more effective through systematized effort, it is doubtful whether the size of the bureaucracy can be cut at all—particularly in light of the fact that there are 30 million jobless enrolled in the nation's employment exchanges (and countless others unaccounted for). As one economist pointed out recently, in India three out of every four employees in the non-agricultural formal sectors work for the government. Since the bureaucracy cannot be cut overnight, proposals have been made to freeze new hiring and sell off some of the public enterprises.

The continuing failure of the public sector units to generate an adequate surplus is a major contributor to India's growing internal debt problem. With an investment of some $50 billion, the public sector companies provide a return after tax and interest payments of less than 3%—in a good year! If the petroleum sector is removed from the calculation, the public sector's return would be invariably negative. If depreciation is accounted for, the public sector enterprises are busy accumulating dissavings.

A looming financial crisis has put a question mark on the capital outlay for the Eighth Plan. The major concern of policymakers at this time is how to finance the plan. Since foreign loans and grants account for less than 10% of the plan's developmental expenditure, it is the growing internal debt that has made the plan's future shaky.

India's five-year developmental plans are financed principally by domestic savings—90% of which come from household savings. But there are now clear indications that household savings has reached a plateau, in utter defiance of planners' expectations that it would grow at a faster rate. As it is, India's household savings are very high. Gross household saving as a percentage of personal disposable income grew to 21.2% by 1978-79, and then rose to 21.9% in 1987-88.

This leaves the government with nothing but corporate sector savings to draw on. Historically, the performance of this sector in savings is poor, and the scope for any significant improvement seems to be wishful thinking unless measures are undertaken to drastically improve the sector's productivity.

Whither the Eighth Plan?

Besides worrying about how to finance the plan, there has been a raging controversy regarding what the plan should achieve. There is unanimity in the view that poverty alleviation is the prime objective; the disputes lie in how to make it happen. The planners brought in with Prime Minister V.P. Singh's administration, who come from a strong social democratic background, claim that the objective of the plan should be to provide employment, and should be formulated to bring about large-scale job creation. They argue that centralized planning, adopted by India in the early 1950s, has failed to achieve the goal of alleviating poverty and is in fact responsible for the existing high unemployment. They demand that centralized planning be scrapped forthwith, and that a decentralized set-up take its place. Districts, provinces, and regions would decide for themselves what the developmental plan should be for their area.

The planners have also strongly emphasized the necessity of putting more effort into the social sectors such as education and health care. Finally, the new group of planners have brought to the fore the concept that the planning process is meant only to direct and guide development in the priority areas.

But since the planners failed to concretize their formulation in terms of targets for investment and achievement, they

TABLE 4
Internal debt doubles in five years
(billions of $ at present exchange rate)

Year	Amount
1985-86	41.8
1987-88	56.8
1989-90	78.4
1990-91	88.8 (est.)

came under serious attack. Even Prime Minister V.P. Singh made it clear that he would like to know the commitment in a concrete form. Deputy Prime Minister and Minister for Agriculture Devi Lal, who represents the farm sector in the cabinet, said in no uncertain terms that power and irrigation are the keys to boosting agricultural productivity and rural development, and demanded that these be financed by the center. Energy Minister Arif Mohammad Khan has called for a plan outlay close to $50 billion to shore up India's energy sector with another 38,000 megawatts of electrical power capacity during the plan period. Adding to the din, Minister of State for Environment and Forestry Maneka Gandhi has been asking for a plan which would stop further degradation of India's already degraded environment.

Amidst the cacophony it is difficult to determine which way the plan will ultimately go. Coming back from their flight of fancy to *terra firma,* the planners did finally recommend an average annual GNP growth rate of 5.5% during the plan period. It seems they bowed to the general demand that employment can be generated only through sustaining long-term growth. While direct assistance to the poor, to allow them to build up "assets"—another demand that was in fact included in the last two plans—has been widely acknowledged as a requirement for reducing poverty, it has also been argued that such assistance can be provided only if the country produces a surplus generated through adequate growth of the economy. The real problem with the Indian economy is its low productivity in almost all sectors. It is for this reason that the incremental capital-output ratio, a measure of how capital invested is working, remains extremely high.

Still, the biggest dilemma that the economy faces today is not so much the internal debt, but how to overcome the inertia of stagnation, particularly in the largely unproductive agricultural sector where almost 70% of the workforce is located. This sector is helping to drag the economy down though it has the potential to do just the opposite. Behind agriculture's low productivity is the abysmal condition of India's rural infrastructure.

The answer to this problem was articulated years ago by American economist Lyndon H. LaRouche, who recommended that India initially use labor-intensive methods, since the rural sector has no shortage of unskilled manpower, to develop rural infrastructure. He argued that the process will not involve foreign exchange risk, will provide gainful employment, and will help unskilled agricultural laborers to learn the new skills necessary for the next phases of development. This viewpoint was recently echoed by the Indian economist M. Narasimham in an address in Bombay. "Rural infrastructural investment can also be made labor-intensive," said Narasimham. "The provision of employment engaged in construction of such infrastructure provides scope for the savings potential of disguised unemployment to be converted into productive rural capital assets."

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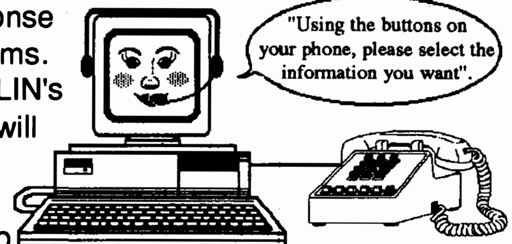

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