Journal of Stock & Forex Trading
ISSN: 2168-9458

Shubhada, J Stock Forex Trad 2015, 4:2
DOI: 10.4172/2168-9458.1000146

Research Article Open Access

Bypassing the Debt Trap – Indian Perspective

Shubhada Sabade*

Faculty of Economics in SIMS, Symbiosis International University, Pune, India

***Corresponding author:** Shubhada Sabade, Faculty of Economics in SIMS, Symbiosis International University, Pune, India, Tel: 020-30213250; E-mail: shubhada.s@sims.edu

Received date: Nov 10, 2014; **Accepted date:** February 28, 2015; **Published date:** March 07, 2015

Copyright: © 2015 Sabade S. This is an open-access article distributed under the terms of the Creative Commons Attribution License, which permits unrestricted use, distribution, and reproduction in any medium, provided the original author and source are credited.

Abstract

Over the last two decades, India has been running deficits in both revenue account and overall budget adding to the public debt each year. Fiscal profligacy of many state governments has added to the woes of the center by further raising the combined debt burden. External debt becomes another worrisome aspect especially when cross-border flows become volatile during crises and rating agencies are waiting in the wings with a downgrade threat. As soon as the debt crosses a certain threshold level, the financial markets become unwilling to buy government bonds and suddenly the deficit starts appearing unsustainable, bonds get junked, further lowering sovereign ratings and a debt crisis can emerge. Evidently, precaution is better than cure and it's essential to foresee a debt trap and bypass; escape or circumvent it by fiscal prudence. Fiscal prudence is not just about reducing deficit numbers; it's about quality of government expenditure reflected in generation of productive assets and elimination of revenue deficit. This paper attempts to assess India's fiscal situation particularly by identifying the possibility of a debt trap and suggests ways and means to improve the situation.

Keywords Debt trap; Primary deficit; Capital expenditure; Monetary policy

Introduction

Economists have attempted to assess the solvency, stability and sustainability of India's public debt. Some literature suggests the possibility of India entering a debt trap soon. Debt trap is a situation when the country needs to borrow to pay the interest on the inherited debt, thus further raising its loans and interest obligations. If a country is on the verge of entering a debt trap, or is already in a debt trap, it becomes necessary to examine whether the excessive government expenditure incurred has been productive enough through asset-creation so as to raise government revenues from which to service the loans which could undo the debt trap situation. Another issue is whether Indian government owes this debt to Indians or foreign countries. Due to the relatively higher domestic interest rates, India has started borrowing from abroad which has raised India's external debt in absolute terms. This makes the economy vulnerable to external shocks during volatile capital cross-border flows.

As mentioned in the Occasional paper of the South African Reserve Bank in 1993 [1] the economic literature provides at best only a vague description of debt trap. The paper gives the following 2 definitions of debt trap: 'Debt trap is generally described as an unsustainable level of and rate of increase in the government debt where a continued rise in the ratio of government debt to GDP cannot be prevented.' 'Debt trap is defined as an 'explosion' in government debt and interest payments, in conditions in which even the maximum attainable (politically practicable) reductions in the non-interest budget deficit would be inadequate to prevent such an explosion.' Or, 'Debt trap is an unsustainable government fiscal position wherein an 'explosion' in government debt ratio can no longer be prevented by an increase in tax ratio or decrease in discretionary (non-interest) ratio. Bhattacharya and Shrabani Guha say in EPW 14 Apr 1990 [2] that there is a general agreement that if internal public debt grows continuously and moves to a self-sustained growth path then it may lead to a debt trap, hyper-inflation and financial crisis. In common parlance, debt trap indicates having to borrow to pay interest on prior loans and operates at individual, company, state and country level. This paper proposes a definition of debt trap and measurement indicators at all-India that is the Central government level, although may occasionally mention the combined centre + state deficits or debts.

I would like to define 'debt trap' as an unsustainable fiscal situation wherein the government's debt to GDP ratio has been rising for 5 consecutive years or over a complete business cycle, whichever is longer, with a rising proportion of external debt to total debt. If it's found that debt trap is not a reality in India today, the paper would further check the movement of the revenue deficit. Thus to identify a debt trap and overall fiscal situation, the following indicators will be used: 1. Debt to GDP ratio; 2. External and internal debt components; 3 Revenue Deficits. In our definition of debt trap, we have presumed an unsustainable fiscal position as a condition for debt trap to occur. So we need to discuss the sustainability issue and choose parameters to identify it. Only if Indian debt is found to be unsustainable, can we move on to find if India is entering a debt trap.

Solvency, Stability, Sustainability Issues

As an RBI study of debt sustainability at state level in India [3] says, solvency denotes positive net worth while sustainability relates more to the sufficiency of liquid assets to meet current or committed obligations. Sustainability embodies concern about the government's ability to service its debt. A government which doesn't generate enough current revenues for debt service, must either default on its obligations or borrow more to service past debt and to cover ongoing imbalances. The paper says that such continual borrowing (Ponzi game) will show up in the time path of debt to GDP ratio which hence becomes an important indicator of sustainability status.

Citation: Shubhada S (2015) Bypassing the Debt Trap – Indian Perspective. J Stock Forex Trad 4: 146. doi:10.4172/2168-9458.1000146

The same study says that a zero primary deficit (Fiscal deficit – interest payment), borrowing to pay interest on inherited debt will not in itself raise the debt stock, and the debt will have been stabilised. Stabilisation indicates fiscal control and serves as a measure of debt-carrying capacity of the economy. Where the debt/GDP ratio shows signs of stabilisation, it's sustainable, irrespective of the level of debt/GDP ratio. Thus to identify signs of stability, we will be using the ratios of primary deficit/GDP and debt/GDP.

Primary revenue deficit indicates net borrowing required to finance current non-interest expenditure, which is unproductive in the sense of not being able to generate debt-financing income. The residual component of overall primary deficit is the primary capital deficit, which can be productive by generating revenues albeit with a time lag. Thus even if the primary deficit is found to be zero and nominal interest and GDP growth rates equal, the economy would still be susceptible to instability if the revenue component is rising against the capital component. Some feel that so long as the government deficit is being readily financed by various entities, there is nothing to worry about. But then, the threshold level often gets ignored. Hence we will also look at the primary and revenue deficits.

As the Occasional Paper of the South African Reserve Bank said, a persistently large fiscal deficit and consequently a rapidly rising public debt could give rise to 4 problems in the economy: 1. Excessive monetisation of debt and eventual loss of control over money supply raising inflation expectations and interest rates. 2. Crowding-out of private sector borrowing and investments, hence slowing of GDP growth rate. 3. Higher fiscal deficit leading to greater Current Account Deficit and BoP position, reducing foreign exchange reserves. 4. Country enters the debt trap. If a country enters the debt trap, domestic and foreign financial markets lose faith in government bonds and stop lending to finance the deficit. The debt overhang traps the economy into a vicious downward spiral and unless arrested quickly, leads to a financial crisis. To avoid the situation, it's of paramount importance to detect the debt trap in time.

Debt Trap and India

'The Economist' warned way back in 2001 [4] that America has a good chance to escape the full, stagnant fate suffered by Japan during the 1990s. But the more the debt trap is ignored, the more the risks will rise. What is said for American economy, is conceptually true for almost any other economy too, including India. The Times of India reported the CAG having warned the Gujarat state government in 2003 [5] that it's gradually getting into a debt trap 'by violating the cardinal rules of debt sustainability. Not only revenue receipts and own resources during 1997-2002 failed to increase at the same pace as debts, there is a net decline in the availability of funds from the borrowings, as a large proportion of funds are used up in debt servicing.' What applied to Gujarat state then, is probably applicable to many states today. But this paper focuses on identifying a possible debt trap for central government on lines CAG used then.

Issues about Debt Trap

Revenue deficit

Revenue deficit is the most important parameter in assessment of the fiscal situation of any government. Revenue expenditure in India can be broadly categorised in administration, defence, subsidies and interest payments. Although some of these are necessary, a large chunk of it such as subsidies and interest payments are not only unproductive, but counter-productive. This revenue expenditure must be met by the receipts on the revenue account and a surplus must be generated. If revenue account shows a negative balance, the government needs to borrow, which raises its loans and hence interest obligations, thus further widening the revenue deficit. This is the debt trap [6].

Fiscal deficit

Although fiscal profligacy must be avoided at all times, it's sometimes necessary to run a fiscal deficit either to counter a recessionary tendency or for development purposes. In India the FRBM Act stipulates targets for the government which have been circumvented, or not adhered to in letter and spirit. But there is nothing sacrosanct about the fiscal deficit numbers. If the revenue account runs a surplus, a fiscal deficit would indicate rise in government's expenditure on capital assets. However a cyclical average must be maintained so that the debt burden doesn't increase beyond a threshold level.

Primary deficit

Primary deficit is the revenue deficit minus interest payments. As mentioned above, a zero primary deficit indicates that the debt would have stabilized since it doesn't raise the debt stock by itself any more [7] (Table 1).

Year#	Revenue Deficit (as % of GDP)	Effective Revenue Deficit* (as % of GDP)	Primary Deficit (as % of GDP)	Fiscal Deficit (as % of GDP)
2004-05	2.5	Na	-0.1	4.1
2005-06	2.6	Na	0.4	3.7
2006-07	2.0	Na	0.1	2.7
2007-08	1.1	Na	-0.9	6.0
2008-09	4.4	Na	2.5	6.4
2009-10	5.2	Na	3.1	5.1
2010-11	3.4	2.9	2.0	5.7
2011-12	4.4	2.7	2.7	5.2
2012-13	3.9	2.5	2.0	4.9
2013-14	3.6	2.2	1.8	4.6

Table 1: Deficits to GDP ratios

Source: 'Budget at a Glance', various Union Budgets

*Effective revenue deficit = revenue deficit – grants for creation of capital

Years are chosen from 2004-05 onwards to cover more than a complete trade cycle.

Citation: Shubhada S (2015) Bypassing the Debt Trap – Indian Perspective. J Stock Forex Trad 4: 146. doi:10.4172/2168-9458.1000144

Debt to GDP ratio centre

Since this paper defines debt trap as a situation wherein the debt to GDP ratio has kept rising over a period, this ratio becomes an important parameter to assess the fiscal situation of the government.

Debt to GDP ratio centre and states combined

Although the debt of the Central Government might look benign, it's possible that the States have a huge debt burden which together looks dangerously close to a debt trap. Although the Centre may lend to the States and States invest in central government bonds, the combined debt needs to be assessed [8].

External / Internal debt components

In case of internal debt, Indians own as many assets as government owns debt mutually. But in case of external debt, India owes it to foreigners and hence becomes a risky proposition especially when foreigners withdraw their funds during global turmoil (Table 2).

Year	Public Debt (as % of GDP)	Internal debt (as % of GDP)	External debt (as % of GDP)	Liabilities of Centre (as % of GDP)*	Liabilities of States (as % of GDP)	General Govt liabilities
2004-05	41.3	37.4	5.9	53.4		
2005-06	40.0	36.7	5.2	51.7		
2006-07	39.4	34.7	4.7	49.6	28.9	73.2
2007-08	37.1	32.8	4.2	46.2	26.6	68.0
2008-09	39.1	34.5	4.7	48.9	26.1	70.6
2009-10	39.9	36.0	3.8	48.8	25.5	70.6
2010-11	37.9	34.3	3.6	45.3	23.5	65.5
2011-12	39.4	35.8	3.6	46.1	22.3	65.5
2012-13	40.6	37.3	3.3	46.7	22.2	66.0
2013-14	40.7	37.3	3.0	46.7		

Table 2: Debt to GDP ratios: external, internal, total, states, combined, *Source*: Government Debt: Status Papers, Ministry of Finance, Deparment of Economic Affairs, Budget Division, New Delhi (July 2013, Nov 2010), *Central Government liabilities = public debt + other liabilities e.g. NSS fund, PPF, Reserve funds etc

Conclusions

Revenue deficit has never been zero or even close to zero in the period studied here. On the contrary it has been on the rise. This indicates that India is close to a debt trap-like situation. Primary deficit was negative twice and close to zero twice in the said period. But otherwise it was always positive especially in the later years, indicating India being close to a debt trap. Debt to GDP ratio, public debt and centre + state combined debt to GDP ratios have shown a mild decline over a period which indicates that the debt is stabilizing. Internal debt has fallen initially and then increased, while the external debt has fallen continually. That is a positive sign and India is not too susceptible to foreign shocks. It indicates that India has adequate savings to finance its own deficits and need not look abroad. Thus the fiscal situation of India is not alarming although it's delicate enough to require immediate attention, lest it should enter the much-feared debt trap.

Recommendations

The revenue deficit must be eliminated at all political costs especially in the first half of the term of a new government. This can be done by drastically reducing subsidies, keeping administrative expenditure under control by keeping the 7th Pay Commission on hold, eradicating corruption, rationalising the tax structure to raise the government revenues.

Capital expenditure may be undertaken to create physical and social infrastructure across the country with the aim to reduce inequalities and disparities, even if it means running a higher fiscal deficit for some time. This is turn will generate more revenues for the government in medium to long term and possibly more votes again in 2019.

Government debt has already stabilised, attempt must be made to reduce it by loan repayment, which will reduce the interest burden, revenue deficit, getting the government on an automatic upward spiral.

Fiscal policy must take precedence over monetary policy so that the two move in sync and the nation moves towards the much-desired aim of inclusive growth while keeping other major problems like inflation automatically under check without unwarranted and lop-sided monetary action. Fiscal prudence is indicated by quality of government expenditure which can put India on an unwinding path away from debt trap for decades to come.

References

1. Van Der Merwe EJ (1993) Is South Africa in a debt trap? South African Reserve Bank.
2. Bhattacharya BB, Shrabani G (1990) Internal Public Debt of GOI-Growth and Composition. EPW 28.
3. Indira R, Shashank B, Pattnaik RK (2005) A Study of Debt Sustainability at State Level in India, RBI.

4. The Economist, Jan 25, 2001
5. Times of India, Ahmedabad, April 3, 2003
6. Budget at a glance: Union Budget 20010-11, 2011-12, 2012-13, 2013-14
7. Government Debt: Status Papers (2010) Ministry of Finance, Dept. of Economic Affairs, Budget Division, New Delhi, India
8. Economic Survey, Ministry of Finance, GOI