Debt Sustainability and Exchange Rate Management

For Prelims: International Monetary Fund, Exchange Rate Dynamics, Credit Ratings, Interlinked Factors Related to India's Rising Debt Levels, Tax evasion**,** Fiscal Responsibility and Budget Management Act, 2003, IMF's Classification of Stabilised Arrangement

For Mains: IMF's Projections Related to India's Economic Outlook, Measures that India can take for Sustainable Debt Management

Source: TH

Why in News?

The **International Monetary Fund (IMF)** recently released its annual Article IV consultation report on India, addressing **critical issues concerning the** nation's debt sustainability **and** exchange rate **management.**

What are IMF's Projections Related to India's Economic Outlook?

- **Debt Sustainability:** The IMF flagged concerns about **India's long-term debt sustainability.**
  - It projected that India's general government debt, encompassing both the Centre and States, could potentially **escalate to 100% of GDP by fiscal year 2028**, particularly under adverse circumstances.
- **Debt Management Challenges:** The report highlighted the **necessity for more prudent debt management practices**, emphasizing the crucial need for **financing to achieve climate change mitigation goals** and enhance resilience against natural disasters.
  - The **Indian Finance Ministry contested the IMF's debt projections**, dismissing them as a worst-case scenario rather than an imminent reality.
- **Exchange Rate Dynamics**: The IMF reclassified India's de facto exchange rate regime to **"stabilized arrangement" from "**floating**"** for December 2022 to October 2023
  - This reclassification reflects observations about **controlled fluctuations in the rupee's value** due to interventions by the RBI.
- **Stagnant Credit Ratings:** Despite being lauded as the fastest-growing major economy, **India's sovereign investment ratings** have remained stagnant for a considerable period.
  - Agencies like Fitch Ratings and S&P Global Ratings have maintained **India's credit rating at '**BBB**- with stable outlook' since 2006,** citing concerns about weak fiscal performance, burdensome debt, and low per capita income.

What is the Global Debt Landscape ?

- **Rising Global Debt:** Globally, public debt has surged dramatically, surpassing **USD 92 trillion in 2022,** a more than fourfold increase since 2000, outpacing the growth of global GDP.
  - According to the UN, in 2022, 3.3 billion people live in countries that spend more on interest payments than on education or health.
  - Developing countries accounted for almost 30% of the total, of which roughly 70% is

attributable to **China, India and Brazil,** largely driven by diverse factors like the **pandemic, cost-of-living crisis, and climate change.**

- **Debt Asymmetry Between Developed and Developing Nations:** Developing countries, including those in **Africa**, contend with substantially higher borrowing costs compared to developed nations.
    - This disparity in borrowing rates compromises debt sustainability for developing nations, leading to **increased interest spending relative to public revenues.**

What is India's Current Debt Scenario?

- **Government Current Debt Levels:** The central government's debt stood at **₹155.6 trillion, approximately 57.1% of GDP by March 2023**. Meanwhile, State governments carried a debt of about **28% of GDP.**
    - As stated by the Finance Ministry, India's public debt-to-GDP ratio is **81% in 2022-23.** This, is way higher than the levels specified by the FRBM target.
        - The 2018 amendment to the FRBM Act specified debt-GDP targets for the Centre, States and their combined accounts at **40%, 20% and 60%, respectively.**
- **Interlinked Factors Related to India's Rising Debt Levels:**
    - **High Fiscal Deficit:** The government consistently spends more than it earns, leading to the deficit being financed through borrowing. This deficit can arise due to:
        - **High Expenditure Commitments:** Social welfare programs, **subsidies**, and defense spending significantly contribute to government outlays.
        - **Slow Revenue Growth:** Tax reforms haven't sufficiently boosted revenue collection, creating a **revenue-expenditure gap.**
    - **Global Geopolitical Events**: Events like the **Russia- Ukraine war** and rising commodity prices can lead to economic disruptions and higher import costs, forcing the government to borrow to maintain stability.
    - **Informal Economy and Tax Leakage**: India's large informal economy poses challenges for efficient tax collection.
        - Tax evasion **and lack of formalization in sectors like agriculture** and small businesses limit revenue generation, potentially forcing the government to rely on debt financing.
    - **Guarantees and Contingencies:** Government guarantees for loans taken by **public sector entities or contingent liabilities,** like potential losses from **public-private partnerships**, substantially add to the debt indirectly.
    - **Exchange Rate Fluctuations**: Fluctuations in exchange rates **impact the cost of servicing foreign currency-denominated debt**, potentially increasing the overall debt burden.
- **Legislation for Debt Management in India:**
    - Fiscal Responsibility and Budget Management Act, 2003 **(FRBM Act): FRBM Act** is an Indian law enacted to bring financial discipline to the government's fiscal operations and to reduce the **country's fiscal deficit.**
        - **FRBMA** aimed for specific debt-GDP targets for the Centre and States.
            - However, disruptions induced by the **pandemic** contributed significantly to elevated debt-GDP ratios, surpassing the specified thresholds.
        - Also, despite several years since its enactment, the Government of India has struggled to meet the FRBM Act targets.

What Differentiates Floating Exchange Rate Dynamics from Stabilized Arrangement?

- **Floating Exchange Rate:**
    - **Market-Driven:** Currency value is **determined solely by supply and demand in the foreign exchange market**, with minimal government intervention.
    - **High Volatility**: The exchange rate can fluctuate significantly in response to economic news, events, or market sentiment.

        - **Promotes Flexibility:** Businesses and individuals can **adjust to changing economic conditions** through market-determined exchange rates.
    - **Stabilized Arrangement:**
        - **More Managed than Purely Floating:** The government or central bank may intervene in the foreign exchange market **occasionally to smooth out excessive volatility** or maintain a target range for the currency.
        - **Moderate Volatility:** Aiming for greater stability than a pure float, but still accepting some degree of fluctuation.
        - **Offers Predictability:** Businesses and individuals can plan with a more stable exchange rate environment.
    - **IMF's Classification of Stabilised Arrangement:**
        - The **IMF** classifies an exchange rate regime as a stabilized arrangement when it determines that the **exchange rate has not moved beyond a 2% band in 6 months** and that this stability has **resulted from market interventions rather than market conditions.**

What Measures can India Take for Sustainable Debt Management?

- **Short Term: Fiscal Consolidation:**
    - **Targeted Reforms: Streamlining subsidies, reforming public sector enterprises, and reducing administrative inefficiencies and strict adherence to FRBM Act targets** can free up resources for debt repayment and productive investments.
    - **Improved Tax Efficiency:** Strengthening tax administration and **tackling tax evasion** can significantly boost revenue without excessive borrowing.
- **Long Term Growth-Oriented Strategies:**
    - **Skill Development and Education:** Investing in human capital **through education and** skill development programs enhances productivity and competitiveness, leading to higher economic growth and improved tax collection.
    - **Export Promotion:** Diversifying export markets**, incentivizing** high-value exports**,** and addressing competitiveness challenges can boost foreign exchange earnings, potentially reducing the need for external debt.

UPSC Civil Services Examination, Previous Year Questions (PYQs)

Prelims:

Q. Consider the following statements: (2018)

1. The Fiscal Responsibility and Budget Management (FRBM) Review Committee Report has recommended a debt to GDP ratio of 60% for the general (combined) government by 2023, comprising 40% for the Central Government and 20% for the State Governments.
2. The Central Government has domestic liabilities of 21% of GDP as compared to that of 49% of GDP of the State Governments.
3. As per the Constitution of India, it is mandatory for a State to take the Central Government's consent for raising any loan if the former owes any outstanding liabilities to the latter.

Which of the statements given above is/are correct?

(a) 1 only
(b) 2 and 3 only
(c) 1 and 3 only
(d) 1, 2 and 3

Ans: C

Mains:

Q. Public expenditure management is a challenge to the Government of India in the context of budget-making during the post-liberalization period. Clarify it. **(2019)**