CHAPTER – VI

INDIA

Background :

The chapter provides comprehensive critical analysis of India's economic performance after independence upto 2000. It essentially followed the inward looking import substitution based foreign trade policy with overvalued rupee for most part of this period. It examines the contribution of fiscal policy with its continuing revenue budget deficit from 1981 that compelled the government to resort to public borrowing even to finance its revenue expenditure. India's public debt went on increasing during this period with increasing volume of interest payment, in turn contributing to revenue deficit. Its monetary policy with increasing rates of CRR and SLR did not leave sufficient funds to be given as loans to trade, commerce and industry in the private sector. This created shortage of credit keeping interest rates on loans very high, making industrial sector non-competitive with the global players, helping the export pessimism thesis to survive. The commercial banks had large portfolio of non-performing assets or non performing loans and they could not earn sufficient profit. During these four decades, beginning from the second five year plan, India had balance of payments deficits year after year, compelling it to borrow from the multilateral financial institutions and friendly countries. India's external debt increased at a dangerously fast pace between 1981 to 1991 and with international events turning unfavourable, India started loosing foreign exchange reserves very rapidly after September 1990 creating the foreign exchange crisis in May – June 1991 when it came quite close to default in honouring its international commitments. During first thirty years upto 1980, India's GDP growth rate was very slow at 3.5% on an average. While the GPD growth rate improved to 5.5% per year during 1981 to 1990, it was accompanied by much higher rate of inflation and unsustainable increase in external debt that created the balance of payments crisis in mid 1991.

India approached the IMF for the financial assistance to tide over the severe crisis and agreed to implement its economic stabilization programme. It followed the fiscal and monetary policy that led to severe contraction in imports and restrained money supply growth. The rate of inflation also came under control. India devalued its currency in early July 1991 by 20% that brought its foreign exchange rate at a level that could be defended. Its GPD growth rate became extremely slow during 1991-92. However, in next three years, India's performance was spectacular in bringing back its economy to high growth rate path with inflation and balance of payments situation under control.

During next seven years upto 2000, India introduced wide ranging structural adjustment reforms in many fields. It has succeeded in correcting weaknesses of the banking sector, and its economy is in much better fiscal health. Most impressive have been reforms in the foreign trade sector with rupee made convertible on current account and permitted non debt creating capital flows reducing its dependence on official external borrowing. However, upto 2000, Indian economy could not improve upon its GDP growth rate, it remained on an average at about 5.5% - the same as during the previous decade. The financial and currency crisis of July 1997 that hit the South East Asian countries, also to some extent adversely affected growth momentum in India. The economic sanctions that were imposed by the UN and the Western countries also slowed down the growth of the manufacturing sector. However, a sound beginning was made during this decade in restructuring economy in a qualitative manner, creating much needed confidence that Indian industries can compete at the global level, that has started showing far better economic performance after 2003.

India, right from the beginning of the second five year plan, had a deficit on the balance of trade and the current account of the balance of payments which was met through external borrowing from the multilateral financial institutions and the friendly countries. This was the reason why India's external debt went on growing plan after plan. In fact, India had its first foreign exchange crisis in 1957 when all its foreign exchange reserves in the form of pound sterling that it inherited from the British Government in India was exhausted as the imports suddenly increased under the impact of the setting up of the big public sector projects including three ambitious steel plants. That marked the beginning of the balance of payments deficits year after year and our need for external borrowing more or less on a regular basis.

It was under the impact of the second oil price increase in 1979 that India's deficit on the current account of its balance of payments widened and

India approached the International Monetary Fund for a line of credit of $ 5.1 billion. The loan was sanctioned but it also brought certain conditionalities against which there was lot of opposition among different quarters. The loan was not eventually fully drawn due to favourable turn in the balance of payments situation and it was repaid before the scheduled time frame. However, India found itself engulfed into even a more serious foreign exchange crisis in the middle of 1991 – May – June 1991. The signs became evident in the second half of 1990-1991 when our foreign exchange reserves began to fall. The proximate cause for the loss of foreign exchange reserves that began from September 1990 was the increase in the crude oil price due to the Kuwait war. The oil price increase brought in its wake a sharp increase in the oil import bill from an average of $ 287 million per month during the period June-August 1990 to $ 671 million per month for the period of next six months from September 1990 to March 1991. This problem got further accentuated by the need to airlift Indian workers employed in Kuwait and as a result of this, their remittances ceased to flow to India. As a result of combination of such factors, India that had foreign exchange reserves of $ 3.11 billion in August 1990, was left with $ 896 million by the middle of January 1991.

The government of India had to take some prompt and drastic measures to arrest any further deterioration in the otherwise very grim situation. In October 1990, the Reserve Bank of India imposed a cash margin of 50% on imports other than capital goods imports, and the latter was allowed only against the foreign sources of credit. The seriousness of the situation can be measured from the fact that this cash margin was raised to 133.3% in March 1991 and to 200% in April 1991. In May 1991, the Reserve Bank of India imposed a 25% surcharge on interest on bank credit for imports. Such strict measures succeeded in achieving a good deal of import compression. The degree of import compression can be seen from the fact that the non oil imports during October December 1990 were 16.8% higher in Dollar terms than a year earlier, but in the next quarter, such imports were 4.1% below the level in the corresponding period of the previous year and in April – June 1991, they were 23.1% lower. The deficit in the balance of trade, as a result of sharp contraction in imports came down steeply from an average of $ 781 million per month during the period October – December 1990 to $ 382 million during January – March 1991 and even lower to $ 172 million per month during April – June 1991.

However, by early 1991, two significant facts regarding India's balance of payments deficit and rapid reduction of the foreign exchange reserves became clear. First, the sharp import compression by severely restricting the imports of the capital goods and the intermediate goods, had started producing adverse impact on the growth of industrial production and exports. Second, it became quite evident by this time that the balance of payments crisis was no longer due to the deficit in the balance of trade. It was primarily driven by adverse developments on the capital account such as withdrawals of NRI deposits, showing a lack of confidence in the government's ability to handle the balance of payments crisis. Moreover, between October – December 1990, India's international credit rating fell sharply and short term credits became increasingly harder to obtain. Such short term credit were available at 0.25% above LIBOR until November 1990, their cost went up to 0.65% above LIBOR in March 1991 and to a further 1.25% by May 1991. Medium term borrowings in the form of bank loans and bonds placed abroad also came down sharply during this period. With such adverse developments on the balance of payments front, the expectations were getting built among the exporters and the importers regarding impending devaluation of the Indian rupee creating longer leads in import payments and longer lags in realization from exports, thus worsening the foreign exchange crisis further. India all along had a practice of maintaining the volume of foreign exchange reserves equivalent of at least three months' imports bill. In sharp contrast, by June 1991, India's foreign exchange reserves covered less than two weeks' imports bill and the county was on the verge of an imminent default in honouring its international commitments.

The new government assumed reins of power in June 1991 and took some measures very swiftly to deal with this extremely difficult situation. Its first and the most important task was to bring back the economy from the brink of default. Towards this objective, the Reserve Bank of India was allowed to ship 47 tones of gold to the Bank of England in July 1991 with which the government could raise about $ 600 million. On first July and third July 1991, India devalued its rupee against the Dollar, this two stage devaluation amounting to 20% fall in the value of the rupee bring it to a credible level which could be defended. Moreover, the government started implementing the IMF's economic stabilization programme through fiscal and monetary measures on an urgent basis.

While the immediate cause of the foreign exchange crisis lay in the sudden and continuous loss of reserves beginning from September 1990, the crisis had deep roots in the economic policy that dominated the Indian scene from the beginning of the second five year plan when we accepted the predominance of the public sector to achieve rapid economic development in the economy that had almost remained stagnant for atleast one hundred years before it achieved independence form the British rule in 1947 with stagnant per capita income at an extremely low level. On this economic strategy was superimposed the import substitution industrialization strategy or inward looking trade policy with the overvalued rupee. In other words, guided by the export pessimism advocated by economists like Nurkse, Prebisch and Singer, Indian policy makers could not appreciate the immense role for the outward oriented export promotion policy. Explaining this great ideological divide between export promotion strategy and import substitution strategy, it is observed, "The first reason for the separation of many economies from the international system derived from the widespread conviction that an alternative set of economic rules or even a different logic applied to developing countries. The differences concerned the appropriate degree of exposure to the international economy and the desirability of domestic financial stability ...... A difference in understanding about the operation of the international economy and the associated conviction that the other side was acting out of fundamentally political logic, profoundly handicapped the IMF in its relations with many developing country of members. Many influential analysts, however, believed that poorer countries would be damaged by exposure to the international system, that emerging manufacturers would be destroyed and that the export of a limited number of commodities would create an intolerable dependence. Access to capital flows would be difficult or impossible.

Some analysts went further than Singer and Prabisch and asserted that the entire process of development was a political struggle. According to this view, developed countries, in order to be able to appropriate for themselves a greater share of the world's resources, had used the theory of neoclassical economics as an ideological instrument. Their insistence on comparative advantage and the mutuality of gains from trade constituted a duplicitous and hypocritical masking of their own exploitative interests. Import substitution strategies on the other hand, might provide an economic basis for the assertion of sovereignity and political independence, as well as self enrichment, by developing countries. If this analysis was valid, the demand for speedy balance of payments adjustment looked like another weapon of developed countries to hold down developing countries below their optimum growth path".[1]

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[1] James Harold, International Monetary Cooperation since Bretton Woods, International Monetary Fund and Oxford University Press, 1996, Chapter 5 Page 124 to 126.

We will now describe fiscal and monetary policies as well as trade and exchange rate polices prior to the economic crisis that struck the Indian economy in mid 1991.

Fiscal Policy :

One proximate cause for the macro economic crisis was the widening budget deficit of the Central Government. The fiscal deficit as a percentage of GDP increased from 6.2 in 1980-81 to 8.4 in 1990-91. Another way of looking at the same phenomenon is that the fiscal deficit on an average was 6.3% of GDP for the period 1980-85 and increased to an average of 8.2% for the period 1985-90. The detailed information is given in the following table :

Table : VI.1 – Central Government Deficit 1980-91[2]

(Per cent of GDP at current market price)

Year	Budget Deficit	Revenue Deficit	Monetised Deficit	Gross Fiscal Deficit	Gross Primary Deficit
1980-81	1.8	1.5	2.6	6.2	4.3
1981-82	0.9	0.2	2.0	5.4	3.4
1982-83	0.9	0.7	1.9	6.0	3.8
1983-84	0.7	1.2	1.9	6.3	4.0
1984-85	1.6	1.8	2.6	7.5	5.0
Average Sixth Plan	1.2	1.1	2.2	6.3	4.1
1985-86	2.0	2.2	2.4	8.3	5.5
1986-87	2.8	2.7	2.4	9.0	5.8
1987-88	1.7	2.7	2.0	8.1	4.7
1989-90	1.4	2.7	1.6	7.8	4.2
Average Seventh Plan	2.1	2.6	2.3	8.2	4.8
1990-91	2.1	3.5	2.8	8.4	4.4

Note : The budget deficit is the difference between all receipts and expenditure, both revenue and capital.

[2] Government of India, Economic Survey 1993-94 Page 15.

The 'revenue' deficit denotes the difference between revenue receipts and revenue expenditure. The 'monetized' deficit is the increase in net RBI credit to central government, comprising of the net increase in the holdings of treasury bills of the RBI and its contribution to the market borrowings of the government. The fiscal deficit is the excess of total expenditure over revenue receipts and grants. The primary deficit is the fiscal deficit less interest payments.

An important factor that contributed to the worsening of the fiscal situation was the gradual increase in the revenue deficit which connotes an unhealthy fiscal development namely the fact that the Central Governments current revenue – tax and non-tax – is not enough to meet its current expenditure which in turn means that the government has to resort to the borrowing even for meeting its current expenditure. The increase in revenue deficit was primarily caused by rising current expenditure as a percentage of GDP while the current revenue as a percentage of GDP remained more or less stable. While the current expenditure as a percentage of GDP increased from 10.8 during 1980-84 to 12.6 during 1985-89 and still further increased to 14.2 in the year 1990-91, the current revenue as a percentage of GDP was 10.0, 11.6 and 10.7 during 1980-84, 1985-89 and 1990-91 respectively. Again the increase in current expenditure was largely due to increase in two items – interest payment on public debt and subsidies. In total central government expenditure, interest payments and subsidies constituted 10%

and 8.5% respectively in 1980-81, these two heads of expenditure accounted for 19% and 10.2% of total expenditure respectively ten years later in 1990-91. The steep increase in interest payment as a percentage of total expenditure also indicates the steep increase in public debt of the central government during this period of ten years. The internal debt liabilities of the central government increased from 35.6% of GDP in 1980-81 to 53.2% in 1990-91. This was contributed by a combination of two factors – rising revenue deficits year after year compelling the government to borrow and poor returns on capital invested in public sector projects and other capital receipts. External debt as a percentage of GDP increased from 9.9 in 1980-81 to 12.3 in 1990-91.

Monetary Policy :

The inflation rate in India has remained at a fairly low level by the developing countries standard with an annual average of 6.1% over a long period of 1951-90. The rate of inflation accelerated in the Indian economy during the second half of 1980s, going to 13.8% in 1991. The following table gives requisite information on growth in money supply and the rate of inflation.

Table : VI.2 – Money Growth and Inflation – Three year moving averages, India 1980-91[3]

Year	M_1 Growth	Inflation Rate
1980-81	5.7	17.5
1981-82	4.8	14.7
1982-83	12.8	10.0
1983-84	12.8	7.0
1984-85	17.1	6.3
1985-86	15.3	7.3
1986-87	15.8	6.0
1987-88	13.4	6.3
1988-89	15.2	6.8
1989-90	16.9	6.7
1990-91	17.2	10.0

While the Indian economy experienced double digit inflation rate in 1980s, it moved around its long term average of 6% for most of the period during this decade. It again stood at 10% for the year 1990-91. By April – May 1991, the inflation rate had steeply risen to 17%. There is reason to believe that the high inflation rates were fuelled by the excessive growth in money supply since 1982. Between 1982-83 and 1990-91, the growth in money supply (M1) moved around 15% exerting upward pressure on the price level. The increase in money supply, in turn, was brought about by the increase in the Central Bank credit to the government i.e. increasing monetization of the budgetary deficit. In the 1980s, reserve money, except for two years 1981-82 and 1984-85, increased at a rate higher than 15% while RBI net credit to the government also increased at a rapid rate. The effect of the monetization of the budget deficit on money supply was

[3] Reserve Bank of India, Report on Currency and Finance, various years.

accentuated by the increase in the money multiplier since 1970s as the branch expansion in rural areas after nationalization led to a reduction in the currency-deposit ratio. The RBI attempted to control the upward drift in monetary expansion by increasing the reserve requirements of the commercial banks. The reserve requirement in India is determined by the Cash Reserve Ratio which was revised in the upward direction since 1973-74 when it was raised to 7%. It was raised to 7.5% in 1981-82 and to 8.5% in 1983-84. Since then it went on increasing and by 1989-90, it stood at 15%. This meant that 15% of the total deposits of the commercial banks had to be kept with the RBI on which they would not earn any interest. Over and above the CRR, the commercial banks are required to maintain the statutory liquidity ratio, which means that the commercial banks have to invest a certain percentage of their total deposit liabilities in liquid assets, the most important of which are the government securities. While the original idea in asking the commercial banks to maintain a certain SLR was to ensure their solvency, in recent years it has become a powerful instrument with the government of taking away a certain percentage of their deposits for investment in government securities for its growing public debt need. In other words, with the help of the SLR, the government can decide the share of the total deposits with the commercial banks for investment in government securities, and the remaining share becoming available to them for making advances to the sectors like trade, commerce and industry. The SLR was 25% in 1964-65 from which level, it went on increasing steadily at regular interval and was at its highest level of 38.5% in 1990-91. Thus, between CRR at 15%, and SLR at 38.5% by 1990-91, the RBI would practically impound 53.5% of the total deposits which would not be available for making advances to trade, commerce and industry. And again, as CRR would not earn any interest and SLR through investment in government securities would earn very low interest rate, this would produce an unfavouragle impact on the profitability of the commercial banks. If we add to this the additional requirement imposed on the commercial banks that of their total advances after meeting the CRR and SLR requirements, 40% will have to be advanced as loans to the weaker sections and the priority sectors at concessional interest rates, the profitability of the commercial banks was bound to be eroded considerably. The implication of such a monetary policy for the economic development of the economy would be frightening as there will be continuous shortage of funds in the credit market, resulting into very high interest rates at which commercial banks were in a position to advance loans to the productive sectors of the economy. With restrictions on the flow of private foreign capital into the economy, Indian industries would be at a serious disadvantage in competing with the industries in the developed countries of the world, helping the self fulfilling hypothesis of export pessimism.

The purpose of priority sector lending was to increase the proportion of credit to the sectors important to the national economy in terms of their contribution to growth, employment generation and more equal distribution of income but which may not receive adequate credit under normal conditions. While these objectives are desirable and have been achieved to some extent, there have been significant costs as well. The priority sector loans are typically given at concessional interest rates and often without adequate safe guards against default. This created strong incentive for dishonest practices and a significant proportion of loans was used up by those for whom they were hardly intended. For example, commercial loans to the small scale industries led many large firms to either sub-divide their operations into smaller parts or to under report their capital assets in order to qualify for such loans. Secondly, political control of public sector banks and consequent lobbying by different pressure groups created a situation where loans were advanced without adequate safe guards against defaults and indifferent attitude towards enforcing repayment. Loan melas and loan waivers to the agricultural sector further added to the farmer's unwillingness to repay loans. This created a complex problem of non-performing assets or non-performing loans which were estimated to be 21% of total bank advances by 1991. Thirdly, priority sector loans at concessional rates imposed an unwarranted burden on the productive sectors of the economy which had to subsidise the cost of such loans.

Thus, the social benefits of the priority sector lending and the weaker sections loans proved to be smaller and the costs much higher than the advocates of bank nationalization and such loans might have originally anticipated. The Narasimham Committee appointed by the government of

India in 1991 to suggest reforms for the improvement of the financial sector recommended that the priority sector loans be reduced from 40% of total bank advances to 10% over the next three years and then should be eventually phased out.

After nationalization of banks in 1969, interest rates in India were usually set by the RBI. While it followed a policy of keeping low interest rates upto mid 1970s, interest rates have been quite high since then. The banks charged 16.5% or even more on loans to the industrial sector, they paid about 12% on long term deposits during 1980-1990 when the average inflation rate was about 10%. Both the rate of inflation and the interest rates were higher than what prevailed in the developed countries.

Capital market was under the government control upto 1991. The controller of Capital Issues regulated the volume and pricing of new share issues in the primary market. While there was a large size mutual fund the Unit Trust of India that was established in 1964 – the private sector mutual funds were not permitted. Similarly, the foreign nationals were not permitted to invest in India's share market, nor were the Indian companies allowed to raise capital in the international share market and debt market. As a result of such restrictions, Indian private corporate sector could not avail of cheaper international funds for investment in industries. On the other hand, external borrowing for the government to finance deficits in the balance of payments year after year and investment in industries in the public sector that could bring to the government extremely low returns in the 1970s and 1980s created favourable conditions for the external debt to increase very fast and for the eruption of the balance of payments crisis in mid 1991.

Foreign Trade and Exchange Rate Policies (1951 – 1991) :

After winning freedom in 1947 from the Britishers, India embarked on ambitious programme of industrialization under the five year plans. Together with predominant position for the public sector to develop heavy and basic industries, India also chose to the import substitution based foreign trade policy with its emphasis on developing many industries at home rather than making imports even when they were cheaper in comparison to the domestic industries. Its another component was export pessimism under which the government did not pursue active policy of export promotion and thus integrating the domestic economy with the world economy.

Imports were regulated through an extensive and an extremely complicated import licensing system and very high import duties. Consumer goods imports were almost banned while in case of capital goods and intermediate goods, quantitative restrictions were used to ensure that goods produced within the country did not get imported. Again imports had been regulated keeping in view the availability of requisite foreign exchange. Capital goods and intermediate goods not produced within the economy were placed on what was known for long time as "Open General License (OGL)" list which consisted on commodities not requiring an import licence. Such imports were also subjected to various restrictions. The OGL imports of capital goods and intermediate goods were subject to the "Actual

User" criterion which meant that the importing firm had to be an 'actual user' itself and was not permitted to sell the imported item for five years without the approval of the licensing authority. The protection provided to the domestic industries by the import licensing system was further strengthened by extremely high levels of tariffs. Thus, India's mean nominal tariff rate in 1988 was 141.2% while the corresponding figure for Brazil was 43% and Pakistan 65.6%.

Behind such high walls of protection, India could develop a large number of diversified manufacturing industries. However, his industrial development could be achieved at very high cost to the economy. Apart from encouraging wasteful and unproductive rent seeking activities among the politicians, beaurocrats and a few industrialists who gained from such policy, the government, by practically eliminating all external competition encouraged indiscriminate and inefficient import substituting industries. Similarly, the domestic industrial licensing system placed restrictions on internal competition allowing monopolies to creep in. The end result of this type of inward looking trade policy was to encourage growth of a high cost, capital intensive domestic industry that obviously could not stand against international competition. With such a trade policy, exports had no major role to play in the development strategy right from 1956 and their growth was looked upon as a marginal activity. Like the imports, the exports of large number of commodities was subjected to quantitative restrictions through an elaborate and complex export licensing system. Thus, there were goods whose export was not allowed, goods whose export was considered on merits on a case by case basis, goods whose export was canalized and could be undertaken only by public sector trading agencies and so on. The objective of such an export policy was to ensure that an essential commodity was not exported when the commodity was in short supply. In other words, this was done to ensure price stability in the domestic market. Secondly, this was done to guard against adverse price movements in those international markets in which India was a large player. Still another objective was to ban the export of certain products so that exports of higher value added downstream products could be promoted which use them as imports.

As many countries following export oriented trade policy, India also could have used depreciation of the rupee to add to the profitability of exports. This did not happen. In fact, throughout most of the post – independence years, India had a grossly overvalued rupee and an extremely restrictive exchange rate regime. Indian rupee was not convertible on both the current account and the capital account of the balance of payments. Inflow of private foreign capital was also restricted and the domestic residents were not permitted to either hold or deal in foreign currencies or shares and bonds. The government of India, through the RBI, was the sole dealer in foreign exchange and the usual practice was to set the foreign exchange rate far below the rate that would clear the market, encouraging parallel market in foreign exchange. There was obviously excess demand for foreign exchange in the economy more or less on an ongoing basis which was dealt through rationing. The government of India had the first claim on the scarce foreign exchange for the import of essential commodities like food, petroleum, defence equipments etc. Only after such imports were taken care of, then the remaining foreign exchange could be released for other imports of the private corporate sector through the import licensing system.

Thus, through 1960s and 1970s upto mid 1980s, India's trade and foreign exchange rate policies remained severely biased against export promotion. And the cost for such policies was paid in terms of lost employment opportunities as India's comparative cost advantage lay in labour intensive exports and in terms of lost growth opportunities as the economy failed to exploit the rapidly growing world markets during this period. While the East Asian economies and the South East Asian economies expanded quite rapidly with the export oriented trade policies beginning from 1980s, India's policies continued to remain inward looking and its share in world exports went on declining steadily from 1.03% in 1960 to 0.43% in 1980.

Between 1955-56 to 1972-73, as the government attempted to restrict balance of payments pressure, the import regime became increasingly more complicated and restrictive. Due to severe import restrictions, the trade balance improved during this period, the economic growth rate remained during this period at an annual average rate of 3.5% while the industrial growth remained almost stagnant. Exports could increase very slowly and their share in GDP already quite small at 5% in mid 1950s came down to 3.5% by early 1970s. The current account deficit on an average remained at 1.8% per year during this period. However, as this deficit was met largely through the foreign aid available on concessional terms, it did not lead to any alarming increase in the external debt.

During 1974-75 to 1977-78, India could experience considerable improvement in its external sector. While it had witnessed the worst inflation episode during two years between June 72 to June 74 – which included the impact of the first oil shock administered by the OPEC countries which increased the price of crude oil for $ 3 per barrel to $ 12 per barrel in October 1973 – when the price level increased by 50%, the government moved quite fast in controlling it. As the inflation rate stabilized, India's real exchange rate began depreciating and within a short period of four years 1974-75 to 1977-78, the Real Effective Exchange Rate fell by almost 30%. The manufacturing exports increased by 24% on an average per year during this period. As a result of such favourable developments, India had a surplus on its balance of trade for the first time in 1977-78 and together with the worker's remittances from abroad, brought about considerable improvement in its current account of the balance of payments. Although the current account improved, the restrictive fiscal and import policies produced unfavourable impact on the growth rate. Between 1970-71 to 1980-81, the manufacturing sector could only grow at an annual average growth rate of 4%, smaller by 1% in comparison to the immediately preceding decade, the GDP could expand only at the average annual rate of 3.1% during this period.

In 1977-78 with the comfortable foreign exchange reserves position, the government slowly began to liberalise its trade policies. Quantitative restrictions, particularly on capital goods and intermediate goods were relaxed. When the second oil price shock took place in 1979 and its adverse effects on price level and balance of payments were experienced in the next two years, the government could continue with its import liberalization policy as its food and foreign exchange reserves position was quite comfortable. Imports increased at the rate of 6% per year during 1980-81 to 1985-86. Exports, however, could increase extremely slowly at the rate of 0.4%. In contrast to the depreciation of the rupee between 1974-75 to 1977-78, rupee appreciation took place between 1978 and 1983. Together with the expansionary fiscal policy which increased income and demand for consumer goods and with weakening world demand in the first half of 1980s, the export performance remained weak. The deficit on the balance of trade increased from an average of 0.6% of GDP between 1970-71 to 1980-81, to an average of 3.3% between 1980-81 to 1985-86. While remittances could help the Indian economy to partly offset its adverse impact on the current account, the government had, none the less, to resort to external borrowing at higher interest rates and for the shorter maturity. With the deficit on the current account amounting to 1.3% of GDP on an average between 1980-81 to 1985-86, India's total external debt increased at the alarming speed from $ 18 billion in 1980 to $ 40 billion in 1986 – it more than doubled within a short period of six years and this was reflected in the deterioration of all its external debt indicators.

The second half of the 1980s experienced a qualitative shift in India's foreign trade policy as the export promotion was placed at the centre of the policy. The incentives to exports were increased and the administrative complexities were streamlined. Export credit subsidies were introduced and their profits were exempted from tax. Among all these export promotion measures, one that influenced the export growth significantly was the devaluation of the rupee from Rs. 12 per Dollar in 1985-86 to about Rs. 16.70 per Dollar in 1989-90. As a result, the exports increased during the second half of the 1980s on an average at the rate of 11% per year in real terms with their increase in Dollar terms being 16% per year. Imports grew at a much slower rate increasing in real term at only 5% per year. As a result, the deficit in the balance of trade experienced an improvement from 3.7% GDP in 1985-86 to 2.8% in 1989-90. However, the other components of the balance of payments were moving in the opposite direction with interest payments on the past debt increasing and remittances from abroad becoming stagnant. As a result, the surplus on the invisible account, an important element providing cushion against the deficit in the balance of payments for long time, started falling particularly after 1986-87. The deficit in the current account of the balance of payments remained higher than 2%

of GDP on an average per year during 1985-86 to 1989-90. The relevant information on this subject is given in the following table :

Table : VI.3 – Key Indicators of India's Balance of Payments[4]

(As percent of GDP)

Year / Period	Exports	Imports	Net / Invisibles	Trade Balance	Current Account Balance
Average 1980-85	5.0	8.4	2.2	-3.4	-1.3
Average 1985-90	5.1	8.2	1.0	-3.2	-2.2
1989-90	6.3	9.0	0.6	-2.8	-2.2
1990-91 (QE)	6.3	9.1	0.4	-2.9	-2.5

While exports as a percentage of GDP did not change much and remained on a average at 5% per year during 1980-85 and 1985-90, imports declined from 8.4% per year during the first half of 1980s to 8.2% during the second half of the decade, resulting into an average trade deficit per year of 3.4% and 3.2% during the first half and the second half of the 1980s respectively. During 1989-90 and 1990-91, exports as a percentage of GDP increased to 6.3, imports also increased, but rather slowly, bringing about the reduction in the deficit in the balance of trade to 2.8% and 2.9% respectively. However, the situation in the current account of the balance showed distinct deterioration during 1985-90 in comparison to 1980-85 due to the steep fall in the net invisibles. Net invisibles constituted 2.2% of GDP per year on an average during 1980-85, restricting the current account deficit as a percentage of GDP to just 1.3. This also indicates that while India experienced the adverse impact of the second oil price increase during 1980 and 1981, and had to seek a line of credit from the International Monetary

[4] Government of India, Economic Survey, 1991-92 Part II, Page 60.

Fund amounting to \$ 5.1 billion, it could bring about considerable improvement in the overall balance of payments situation in the next few years. However, net invisibles as a percentage of GDP came down steeply to 1% during 1985-90. And inspite of a slight decline in the deficit in the balance of trade, the deficit in the current account of the balance of payments steeply increased to 2.2% on an average per year – an increase of almost 70%. Net invisibles as a percentage of GDP fell by another 40% - to 0.6% during 1989-90 and still further to 0.4% in 1990-91, and inspite of the reduction in the deficit in the balance of trade, the current account deficit remained at 2.2% and further deteriorated to 2.5% during 1990-91.[5]

Summing up the balance of payments situation towards the end of 1980s, it was observed that, "while the symptoms of the emerging balance of payments crisis had began to appear during the seventh plan period, the problem was aggravated by global developments subsequently. In particular, the position worsened during 1990-91. The proximate causes for this deterioration were a surge in imports owing to an increase in the POL import bill and a contraction in net invisible receipts as a result of escalation in interest payments. The pressure on the external sector intensified during 1990-91 and the first quarter of 1991-92. During 1990-91, while various medium term adverse factors were still in operation, certain short term factors got superimposed on them. Foremost was the fall out of the Gulf crisis which entailed an additional cost of Rs. 5180 crores (US \$ 2887

[5] Government of India, Economic Survey, 1994-95, Page 87.

million) on the current account alone during the year 1990-91. Secondly, the disturbed conditions in the domestic polity generated unfavourable market perceptions and expectations concerning India. This affected both the current account and capital account components of an already vulnerable balance of payments position and at the same time, made the financing of the former extremely difficult.[6]

The large part of India's external debt was in the public sector and this resulted into an increased interest payment. This being an important item of expenditure on the revenue budget of the government, it led to the deterioration of the fiscal deficit. As the fiscal deficit is financed to some extent by external borrowing, a vicious circle of external debt – deficit came into existence and the external borrowing went on increasing continuously. By 1990, India's total external debt had increased to $ 60 billion and consisted increasingly of short term, high interest rate commercial loans. The relevant information on external debt indicators is given in the following table :

Table : VI.4 – External Debt Indicators of India 1980-1990[7]

	1980	1986	1987	1988	1989	1990
EDT/XGS	136.0	293.1	287.6	280.3	268.3	268.0
EDT/GNP	11.9	21.3	21.9	21.6	23.7	23.5
TDS/XGS	9.3	32.0	29.4	30.3	27.3	26.7
INT/XGS	4.2	14.2	14.0	15.1	14.7	14.5

Note : EDT = Total External Debt
XGS = Exports Goods and Services
TDS = Total Debt Service Payment
INT = Interest Payment

[6] Government of India, Economic Survey, 1991-92, Page 61.
[7] World Debt Tables, 1994

Thus, inspite of increase in exports during 1986-87 to 1989-90, India's external debt situation remained quite precarious. While the ratio of EDT/XGS was 136 in 1980, it rose sharply to 239.1 in 1986 and it remained at a slightly lower level in the second half of 1980s. The ratio of total external debt to GNP was quite favourable in 1990, it practically doubled to the level of 21.3 in 1986 only to increase marginally to almost 24% during 1989 and 1990. While this ratio was not quite alarming particularly if we look at this ratio for the heavily indebted countries of Africa and Latin America during the comparative period. However, the fact remains that external debt was more than doubled within a period of ten years and that its rate of growth was faster than that of GNP. Similarly total debt service consisting of interest payment and repayment of loans constituted about 10% of export earning in 1980, indicating a safe position of the external debt front, it increased by almost three times for each year during the second half of 1980s. In the same manner, interest payment, one component of debt service amount was only 4% of export earnings from which level, it almost increased by three and a half times for each year during the second half of 1980s, indicating that India's Debt servicing situation had become vulnerable from 1986 onwards, without showing any improvement up to 1990.

Between 1950 to 1980, the Indian economy grew at the rate of 3.5% on an average per year. While the growth rate increased to an average of 5.8 during the decade of 1981 to 1990, that was higher than 3% growth rate for all developing countries of the world, the decade also witnessed high inflation rate, deterioration of fiscal and monetary conditions and also deterioration on the external trade and payments situation, bringing it on the brink of a default in honouring its external commitments. While India took some swift and effective economic measures to stem any further deterioration, it had to approach the international Monetary Fund for financial assistance and it also accepted the fund – Bank economic stabilization and the structural adjustment programme.

Under the economic stabilization programme, India had to bring down its high rate of inflation, reduce deficit in its balance of payments, reduce fiscal deficit and bring about reduction in money supply growth, sacrificing in the process, for a short period of three to four years, the objective of high growth rate and expansion of employment opportunities. Towards these objectives, it adopted and implemented wide ranging economic policies.

To bring the deficit in the current account of the balance of payments under control, the government took measures to bring about severe compression in imports. On July 1 and July 3, 1991, within two weeks of assuming power, the new government brought about devaluation of the rupee by about 20% against Dollar. REP licenses were abolished and large part of restrictive import licensing system was replaced by tradable import entitlements linked to exporters' export earnings. This was given a new name - Eximscrips - which was awarded to all exporters upto the value of

30% of their foreign exchange earnings and could be freely used to import practically all items except those mentioned in the restricted list. The established exporters were permitted to maintain foreign currency account and even to raise external line of credit to finance their trade transactions. While presenting the first budget of the new government in July 1991, the finance minister announced that the peak import duty rate would be brought down from 300 percent to 150 percent, while the peak duty on capital goods, project imports and general machinery was reduced to 80 percent. There was a significant change in the country's attitude towards foreign direct investment.

In October 1991, the government negotiated a standby arrangement with the International Monetary Fund for a line of credit of $ 2.3 billion, which was followed by a structural adjustment loan from the World Bank in December 1991. These two major loans together with external assistance from the Asian Development Bank and other bilateral donors, were crucial element in the strategy for managing the difficult balance of payments situation until the new policy measures under the economic stabilization programme could succeed in substantially raising the level of exports. The deficit in the balance of trade and in the current account of the balance of payments remained small, essentially due to the severe import compression during 1991-92.

In March, 1992, Eximscrips were scrapped and replaced by a new system with a larger element of market determined foreign exchange rates –

called the Liberalised Exchange Rate Management System (LERMS) under which the exporters were required to convert 40% of their foreign exchange receipts at the official foreign exchange rate. These earnings were used to buy imports of essential goods like the life saving drugs, fertilizers and petroleum. The remaining 60% could be sold to the authorized foreign exchange dealers at a market determined rate which was generally 20% higher than the official rate and could be used to finance all other imports. With this qualitative change in the foreign exchange rate system, the long existing import licensing system got virtually abolished. Almost all capital goods, raw materials, intermediates and components could be freely imported, subject only to the import duties. The peak tariff rate was also reduced to 110 percent, while the import duty on capital goods and intermediates goods were brought down to 60 percent.

A year later in March 1993, the economy was placed on a unified market determined foreign exchange rate system or a managed floating foreign exchange rate system. From, an official foreign exchange of Rs. 27 per Dollar and a market foreign exchange rate of Rs. 32.50 per Dollar in February 1993, the rupee settled at Rs. 31.50 per Dollar in March 1993 where it remained during the period of economic stabilization programme upto 1993-94. At the same time, the peak tariff rates were reduced in successive budgets from 110 percent in 1992-93, to 85 percent in 1993-94 and to 65 percent in 1994-95. During 1993-94, liberalization in capital account transactions were introduced by allowing foreign institutional investors to invest in capital market and simultaneously, the domestic firms were permitted to borrow from international capital markets. The Finance Minister also made a reference in his budget speech in February 1994 to the prospective move towards full capital account convertibility of the rupee. It has however, not been done in view of the disastrous financial and currency crisis that shattered the South East Asian economies during 1997-98.

Fiscal and Monetary Policies :

The economic stabilization programme that was adopted from mid 1991 introduced number of tax and expenditure measures that led to a fall in the fiscal deficit from 8.4% in 1990-91 to 5.9% of GDP in 1991-92. The revenue deficit was also reduced from, 3.5% of GDP in 1990-91 to 2.6% in 1991-92. The government reduced food and fertilizers subsidies, implemented sale of government equity in some public sector units to private sector corporations, raised the administered price of some petroleum products such as petrol, diesel and cooking gas. In the 1991-92 and 1992-93 budgets, the government took steps to rationalize the direct tax structure by reducing number of deductions and exemptions. At the same time direct tax rates were reduced to increase tax compliance. The indirect tax structure was also simplified and a few industries suffering from inadequate demand like the automobile and television sets were assisted by reducing excise duties on them.

As a part of the economic stabilization programme, the Reserve Bank of India took various measures to regulate the growth of money supply. The stance of the monetary policy in 1991-92 was to control the growth of aggregate demand to fight twin macro-economic problems of high inflation and deficit in current account of the balance of payments. During this year, several important changes were introduced in the monetary policy. The bank rate was changed two times and raised from 10 percent to 12 percent. Similarly interest rates on term deposits were also raised significantly. Interest rates on bank advances of all categories were revised upwards to control inflation. Larger export credit refinance facilities were introduced to provide incentive to the banks in their credit support to the exporters.

The Reserve Bank of India took some credit control measures to bring down the rate of inflation. It imposed 10% incremental cash reserve ratio on the increase in net demand and time liabilities of the scheduled commercial banks on 3rd May 1991 level. It withdrew all refinance facilities, except export credit refinance facility.

All such measures led to a decrease in reserve money and money supply growth from 13.4% and 23.6% in 1992-93 to 11.5% and 7.3% in 1993-94 respectively. Growth in foreign exchange reserves also slowed down in 1992, though there was an increase in bank credit to the commercial sector in the same year as compared to the previous year. The slow down in monetary expansion was partly responsible for the reduction in the inflation rate from 13.8% in 1991-92 to 10.1% in 1992-93.

The Indian economy could bring about a good deal of turnaround in its macro economic performance during a short period of three years – 1991-92, 1992-93 and 1993-94. The details are presented in the following table :

Table : VI.5 – Key Indicators[8]

	1990-91[9]	1991-92	1992-93	1993-94
Gross Domestic Product (A+ 1980-81 Prices)	5.6	0.9	4.3	4.3
Agricultural Production	2.6	-2.0	4.1	2.2
Industrial Production	8.5	0.6	2.3	4.1
Wholesale Price Index	12.1	13.6	7.0	10.8
Consumer Price Index for Industrial Workers	13.6	13.9	6.1	9.9
Money Supply (M_3)	14.9	19.4	15.7	18.2
Imports at Current Prices (US $) %	13.2	-19.4	12.7	6.1
Exports at Current Prices (US $) %	9.1	-1.5	3.8	19.6
Foreign at Currency Assets (US $ Million)	2236	5631	6434	15068
Exchange Rate (Rs. / US $)	20.0	24.65	28.96	31.37
External Debt ($ Billion)[10]	-	71.6	77	85.2
Debt Service Ratio % of Exports	26.7	29.0	25.6	31.01

With the help of number of economic measures taken with a view to stabilize the economy, the government could place it back on the growth path. The year 1991-92 witnessed significant contraction in the GDP growth rate which was slightly less than I percent in contrast to 5.6% achieved during 1990-91. Agricultural production declined by 2%, but that was obviously not due to the economic stabilization measures. The industrial production could grow at only 0.65 during 1991-92. This was due to very

[8] Government of India, Economic Survey, 1994-95 Page 2.
[9] Government of India, Economic Survey, 1991-92 Page 2 for figures relating to 1990-91.
[10] Asian Development Bank, Asian Development Outlook, Page 138.

severe import compression that the government had to enforce as there was rapid fall in the foreign exchange reserves beginning from September 1990. Necessary imports of raw materials and intermediate goods had to be restricted because of shortage of requisite foreign exchange reserves, and the industrial sector could respond to it only through reduction in output. The inflation rate measured with the help of wholesale price index and consumer price index continued at high level during 1991-92 as in the previous years, while expansion of money supply was much faster. The impact of the economic stabilization measures can be appreciated from the negative growth rate of imports and exports. While the merchandise imports steeply declined by almost 20% during 1991-92, exports also fell though by smaller proportion. Foreign currency assets increased during 1991-92 in comparison to previous year by something like $ 3 billion largely due to the timely sanction of financial assistance by the International Monetary Fund. The foreign exchange rate was raised to a level that could be defended without causing any unwarranted panic in the foreign exchange market with credit measures taken to improve the balance of payments situation. The debt service ratio increased during 1991-92 as the export earnings had declined while debt servicing amount increased in view of the rising trend in external debt.

However, during 1992-93 and 1993-94, the Indian economy could achieve significantly higher rate of GDP growth – 4.3% in both the years though it was still lower than this rate achieved in the year 1990-91. The industrial sector could not fully recover to the pre crisis year level. Though it showed signs of recovery. Import growth recovered in 1992-93, but again slowed down in 1993-94. Exports started responding to the far reaching changes in the external trade and foreign exchange rate policies which were continuously being changed in the direction of integrating the Indian economy with the world economy. While the external debt increased to a level of $ 85 billion in 1993-94, the foreign exchange reserves also increased considerably from almost $ 6.5 billion to $ 15 billion – increase of 150% in a single year as the government liberalized its policy with respect to foreign direct investment, portfolio investment and allowing ambitious Indian private sector corporations to raise capital from the international capital market. Value of rupee was adjusted to keep its level at an appropriate level consistent with the balance of payments situation. One area where the reform measures succeeded was the control of inflation during 1992-93 and 1993-94. While the rate of inflation measured with the help of wholesale price index and the consumer price index still remained at 10%, it certainly came down from the earlier level of price rise which appeared now quite sustainable.

The most impressive performance of the Indian economy was recorded in the external trade sector where the balance of payments crisis had originated. This improvement can be seen from the following table :

Table – VI.6 : Balance of Payments : Key Indicators[11]

(As percent of GDP)

Items	1990-91	1991-92	1992-93	1993-94
Exports	6.2	7.3	7.8	9.1
Imports	9.4	8.4	9.8	9.6
Trade Balance	-3.2	-1.1	-2.0	-0.5
Invisible Balance	-0.1	0.7	0.2	0.4
Current Account Balance	-3.3	-0.4	-1.8	-0.1

While imports as a percentage of GDP, after having decreased in 1991-92 to 8.4, remained more or less at the level at which they were in 1990-91 – it recorded a marginal increase. Exports as a percentage of GDP, however, went on increasing year after year and were almost 50% higher in 1993-94 as compared to 1990-91. The outward oriented external trade policy had started yielding favourable result within a short span of three years justifying the policy measures adopted under the economic stabilization programme. The deficit in the balance of trade that had reached an unsustainable level -3.2% of GDP, quickly came down under the impact of severe import compression to 1.1% in 1991-92. While it increased to 2% in 1992-93, it was at an extremely low level of 0.5% in 1993-94. The invisible balance had become negative during 1990-91, accentuating the deficit in the balance of trade, instead of providing the cushioning effect as it did during most of the years of 1980s, but turned positive during the next three years.

[11] Government of India, Economic Survey, 1994-95 Page 87.

As a result of all these factors, the deficit in the current account of the balance of payments that had reached the unsustainable level -3.3% of GDP in 1990-91 and triggered the most serious foreign exchange reserves crisis in the post independence period, came down significantly to only 0.4% of GDP in 1991-92. While it increased during 1992-93, it reached an extremely low level -0.1% in 1993-94. With increase in the exports and imports, as a percentage of GDP, the Indian economy was increasingly, getting integrated into the world economy. With sizable increase in the foreign exchange reserves during these three years, an environment was created for the inflow of non-debt creating capital into the economy in sharp contrast to only debt creating inflow of foreign capital in the form of loans from the multilateral financial institutions and other sources.

The qualitative improvement in India's balance of payments can also be seen with the help of another set of figures presented in the following table :

Table : VI.7 – Ratios of Selected Items of the Balance Payments[12]

		1980-81	1990-91	1991-92	1992-93	1993-94
1.	Exports / Imports (%)	52.4	66.2	86.7	81.2	94.6
2.	Current Account/GDP (%)	-1.6	-3.3	-0.4	-1.8	-0.1
3.	Current Account Deficit (US $ Million)	2095	9680	1178	3526	315
4.	ECB / TC (%)	10.9	26.8	30.6	-8.4	9.1
5.	NRI Deposits / TC (%)	9.7	18.3	6.1	47.0	10.2
6.	External Assistance/TC (%)	60.9	26.3	63.9	43.7	18.5
7.	Debt Service Payments as a % of Current Receipts	10.2	32.3	29.8	30.3	24.8

Notes :
1. TC : Total Capital Flows (Net)
2. GDP : Gross Domestic Product
3. ECB : External Commercial Borrowings
4. As total capital flows are netted after taking into account some outflows, the ratios for item no. 4, 5 and 6 may in some cases add up to more than 100.
5. Debt service payments for the year 1980-81 exclude defence debt.

[12] Government of India, Economic Survey, 1994-95 Page 85.

Exports accounted for only 52.4% of imports in 1980-81 creating a large deficit in the balance of trade. While this ratio went on increasing, it was still at a substantially low level – 66.2% - in 1990-91. During the next three years during which the government of India implemented the economic stabilization programme, this ratio went on increasing sharply and stood at a high level of 94.6% in 1993-94, implying that the merchandise exports could pay for almost 95% of the merchandise imports. Of the total capital flow (net), external commercial borrowing accounted for 10% in 1980-81. However, it increased substantially during the second half of 1980s when during the year 1986-87, it accounted for 48.1% of the total capital flow (net). Almost 50% of the capital inflow required to finance the deficit in the balance of payments on current account was secured through external commercial borrowing from the private financial institutions at considerably high interest rates than other sources of securing external capital inflow. While it came down in subsequent years, it was still much higher at 26.8% in 1990-91 than in 1980-81 adding considerably to the interest payment on external debt. While it continued to remain at a high level in 1991-92 - 30.6% - it sharply declined to less than 10% during 1992-93 and 1993-94. NRI deposits constituted 9.7% of total capital flow (net) in 1980-81, their role in financing current account deficits increased considerably during the second half of 1980s. Its importance gradually came down and accounted for only 6.1% of total capital flow (net) during 1991-92. However, it went up to 47% in 1992-93 when external commercial borrowing turned negative. In

1993-94, NRI deposits as a percentage of total capital inflow was 10.2%, much smaller than what it was in 1992-93 and practically at the level attained in 1980-81. In any case, NRI Deposits as a source of external capital increased significantly during the second half of 1980s and showed wide fluctuations, depending on government's interest rate policy and their perception about India's ability to defend its foreign exchange rate. External assistance provided by the multilateral financial institutions was by far the most important and dependable source of securing foreign capital to pay for the current account deficit. It accounted for almost 60% of net capital inflow in 1980-81. From this time onwards, India started borrowing from the private commercial banks on which it has to pay much higher rate of interest and was short term in nature. With increasing dependence on external commercial borrowing and NRI deposits, our dependence on external assistance from the multilateral financial institutions went on decreasing year after year and while it accounted for almost three fifth of total net capital inflow in 1980-81, it was only 26.3% in 1990-91. As India had to approach the International Monetary Fund and the World Bank for the immediate financial assistance in 1991-92, its proportion increased to about 64% and the deficit in the current account became manageable in size. India's dependence on this source came down to only 18.5% in 1993-94.

While external commercial borrowing, NRI Deposits and external assistance were in the form of debt creating capital flows and went on adding to the external debt of India, another source of external finance of a fundamentally different nature in terms of its impact on the volume of external debt was slowly coming into prominence. It is called foreign investment with three subcategories – Direct foreign Investment, Foreign Institutional Investors (FIIs) or Portfolio Investment and Euro Equities or Indian Private Sector corporations enjoying a certain level of financial standing in the international financial markets raising capital through the issue of equity and bonds.[13] While DFI was a small amount - $68 million – in 1990-91, it increased to $ 154 million, $ 344 million and $ 620 million during 1991-92, 1992-93 and 1993-94 respectively. While it was still less than $ 1 billion in size in 1993-94, it was almost 10 times larger than what it was in 1990-91. There was an explicit provision encouraging the flow of DFI in 1991-92 budget. Similarly, capital inflow under other two categories began from 1992-93. And while portfolio investment was of an insignificant quantity – only $ 1 million – in 1992-93, it jumped steeply to $ 1665 million in the very next year 1993-94. In the same way, once the euro equities were permitted, they brought in foreign capital of $ 240 million in 1992-93 and then it sharply increased to $ 1460 million in 1993-94. In fact, portfolio investment and euro equities for which the permission was given later than that given to DFI, the foreign capital inflow on account of the former was more than double the size of the former in 1993-94. The deficit in the current account in 1992-93 was $ 3536 million, while capital inflow on account of foreign investment was $ 585 million. In the next year 1993-94,

[13] Ibid Page 87.

current account deficit was $ 315 million while capital inflow under the head – foreign investment –was $ 4110 million, far in excess of the deficit and contributing to the building up of foreign exchange reserves. While India's foreign exchange reserves had declined by $ 1278 million in 1990-91, there was an addition made to it of the size of $ 3576 million, $ 728 million and $ 8868 million during 1991-92, 1992-93 and 1993-94 respectively. The inflow of foreign capital under foreign investment indicates flow of capital on private account – the form of movement of foreign capital that prevailed all throughout 19th Century and upto 1946 in the 20th century when John Maynard Keynes negotiated the first official loan from America for England and also carries the interest and dividend burden for the recipient country. However, it does not add to the government debt and its debt service commitment. If anything, the government's debt service payments as a percentage of current receipts that was quite high at 32.3% - the highest since 1980-81 went on falling during the next three years and stood at 24.8% in 1993-94 which was still two and a half times higher than what it was in 1980-81. Thus, the economic stabilization programme that was initiated in 1991-92 succeed in correcting India's balance of payments disequilibrium in a satisfactory manner with the help of the economic measures in the field of foreign trade as well as foreign exchange rate policies.

In comparison to some large developing countries of the world, India accepted economic stabilization and structural adjustment programme much later. The relevant information on their foreign exchange reserves is given in the following table :

Table : VI.8 – Foreign Exchange Reserves in selected countries, 1990-94[14]

(In $ million)

Country	1990	1991	1992	1993	1994 (Latest)
India	1205	3580	5461	9807	19604[3]
China[1]	28594	42664	19443	21199	39969
Indonesia	7353	9151	10181	10988	11021
Malaysia	9327	10421	16784	26814	29689
South Korea	14459	13306	16639	20804	23404
Thailand	13247	17287	20012	24078	28321
Taiwan[2]	35790	40275	43534	44295	42622

Import Cover (Number of Months)

India	0.6	2.1	2.8	5.2	8.2
China	6.4	8.0	2.9	2.5	4.6
Indonesia	4.0	4.2	4.5	4.7	4.7
Malaysia	3.8	3.4	5.0	7.1	7.8
South Korea	2.5	2.0	2.4	3.0	3.4
Thailand	4.8	5.5	5.9	6.3	7.4
Taiwan	7.8	7.7	7.2	6.9	6.6

Notes :
1. Prior to 1992, foreign exchange included foreign exchange holdings of the Bank of China also and from 1992, it includes foreign exchange holdings of the People's Bank of China only.
2. Total reserves minus gold.
3. Foreign currency assets at end-January 1995.

Source : International Financial Statistics – IMF 1996.

In 1990, India had the smallest amount of foreign exchange reserves – only about $ 1 billion – among these seven large developing countries, while South Korean and Thailand had $ 14 billion and $ 13 billion foreign exchange reserves respectively. China had $ 28 billion foreign exchange reserves while Taiwan had the largest amount of reserves among these seven

[14] Ibid, Page 91

countries. India's foreign exchange reserves registered the fastest growth from $ 1 billion to $ 19 billion and the foreign exchange reserves of the remaining six countries also recorded comfortable growth. However, if we look at the figures relating to the import cover, India's performance turns out to be the best among this group of seven countries. In 1990, India had foreign exchange reserves that could pay for the import bill of just a fortnight, while China's figure was 6.4 and that for Taiwan was 7.8. In1994, India had foreign exchange reserves enough to pay for 8 months imports. Next in the comfortable position in this respect was Malaysia, Thailand and Taiwan. Taiwan and Thailand could maintain high import cover for all these years in the first half of 1990s. India could come out of its vulnerable position regarding foreign exchange reserves within a short period of 3 years, justifying the usefulness of the new set of economic polices that it adopted in mid 1991.

Right from early 1980s when the countries affected by severe balance of payments crisis adopted the economic stabilization programme of the International Monetary Fund, it was thought that such policy reforms might hurt the poorer sections of population because of temporary reduction in job opportunities, resulting from demand restraining policies, or even permanent loss of employment in certain industrial activities resulting from the wide ranging structural change. Tendulkar examined this aspect of the performances of the economic stabilization programme.[15] His estimates

[15] Tendulkar S, 'Indian Economic Policy Reform and Poverty : An Assessment' in Isher J Ahluwalia and I.M.D. Little (eds) India's Economic Reforms and Development : Essays for Manmohan Singh.

showed that the incidence of both rural poverty and urban poverty, went on falling steadily throughout 1980s and this trend was reversed for a short period during the years of Economic Stabilization Programme. His analysis shows an increase in the incidence of poverty in the urban areas as well as rural areas in the first two years 1991-92 and 1992-93. However, this trend was reversed in 1993-94. In case of urban poverty, the reversal of trend was complete and the incidence of urban poverty in 1993-94 was in fact lower then in 1990-91. However, the incidence of rural poverty in 1993-94, was marginally higher than in 1990-91. He also examined the related issue whether the increase in poverty was in some way caused by economic stabilization programme. His explanation for the increase during these three years in rural areas is given in terms of decline in food grain production in 1991-92 which reduced rural incomes and led to the increase in food prices which reduced consumption levels of the poor in the urban areas as well as the rural areas. According to him, increase in food prices was mainly due to fall in the food grain production which had nothing to do with the reforms. However, the devaluation of the rupee in July 1991 led to increase in import parity price and as a result of this, also domestic market price of food grains.

The economic survey 1994-95 observed, "The economy has thus moved to a more stable and sustainable balance of payments position in the last four years. As was expected by the government and contrary to the fears in some quarters, trade liberalization and a shift to a market determined exchange rate regime have had a significant positive impact on the country's balance of payments position".

The economic survey 1994-95 also struck a note of caution. It observed, "Compared to other countries coping with crisis and adjustment, the restoration of macroeconomic stability and revival of growth in output and employment has been exceptionally smooth. But these undeniable achievements are not free from threat. The Central Government fiscal deficit continues to be high and this is reflected in continuing inflationary pressure. The borrowing requirements of a high fiscal deficit are a source of pressure on interest rates, and adversely affect the availability of resources for productive investment, especially at a time when a strong industrial recovery has resuscitated private sector demand for investible funds. Inadequate supply of quality infrastructure, especially power, is also an important constraint which could prevent the economy from achieving its full growth potential. Nor is the hard-won relaxation of the foreign exchange constraint immune from reversal. Unless fiscal restraint is observed, and reforms in tax and trade policies continued, the recent improvement in international competitiveness and export growth could falter and thus bring the balance of payments under renewed stress. Moreover, in today's increasingly open and competitive international environment, perceptions of weakness in macroeconomic policy or economic reforms could easily affect adversely the flow of foreign savings".[16]

Once the Indian economy could achieve satisfactory turn around during the three years period 1991-92 to 1993-94, it started introducing structural reforms having far reaching implications for its various sectors.

[16] Government of India, Economic Survey, 1994-95 Page 85.

The period beginning from 1994-95 constitutes the post economic stabilization period when the focus of policy was on the longer-term objective of putting the economy on a higher growth path by achieving sustainable acceleration in growth. India's efforts at structural reforms covered the familiar gamut of decontrol of private investment, opening up of the economy to foreign trade and foreign investment, financial sector reforms, etc. However, such market oriented reforms were also supplemented by efforts to strengthen various anti poverty programmes reflecting a widely shared perceptions across the vast political diversity of its system that liberalization by itself would not be able to ameliorate the economic conditions of the poorest sectors of the society.

Financial Sector Reforms :

The structural adjustment programme aims at reallocating real resources in the economy among various sectors and this process needs to be lubricated by an efficient financial system. In 1997, the government appointed a second committee on Banking Sector Reforms also under the chairmanship of M. Narasimham to review what could be achieved between 1992-97 and to make recommendations for the second stage of banking sector reforms. The second Narasimham Committee submitted its reports in 1998. High statutory Liquidity Ratio (SLR) before 1991 coupled with high Cash Reserve Ratio (CRR) had virtually crippled the ability of the commercial banks to meet the credit requirements of trade, commence and industry. The average SLR was brought down form 37.4% at the end of

March 1992 to 29.5% by end of March 1995. In October 1997, SLR was reduced to 25% on the lines recommended by the Narasimham Committee. CRR was reduced from 10% to 9.5% in two stages during October-November 1997, and then raised in two stages to 10.5% with effect from January 17, 1998 and then again reduced in two stages to 10% with effect from April 11, 1998. The changes in CRR took place to counter the unusual movements of the foreign exchange rate after July 1997 when the South East Asian countries were severely hit by the financial and currency crisis. The Reserve Bank of India took steps to strengthen the Bank Rate as a policy instrument for transmitting signals of monetary and credit policy. It would also serve as a reference rate for other interest rates in the financial markets. Under the structural reforms, the need for a reference rate has become stronger, as there is a policy shift from direct instruments of monetary policy such as administered interest rates and reserve requirements to indirect instruments such as open market operation for monetary management. The 1% reduction in the bank rate each in April, June and October 1997 signaled the beginning of a low interest rate regime as these downward movements resulted in similar reductions in deposit rates and lending rates of the commercial banks. However, this policy of low interest rates had to be quickly reviewed in the next few months to counter the speculative activity in the foreign exchange market that took place in the wake of the severe financial and currency crisis in the South East Asian countries. As a result of this, the bank rate was increased by 2% to 11% on January 16, 1998.

However, as this measure was taken to meet the difficult situation arising out of unusual movements in the foreign exchange market, the Reserve Bank of India subsequently reviewed the monetary and credit situation and reduced the Bank Rate to 10.5% and 10% on March 18, 1998 and April 2, 1998 respectively. The Bank Rate was further reduced to 9% in April 1998. In response to promotional measures announced in the Union Budget 1999-2000, the Reserve Bank of India reduced the Bank Rate by1% to 8% and reduced CRR from 11% to 10.5% in March 1999.

A major change in the conduct of the monetary policy was brought about by the Reserve Bank of India in April 1999 following the recommendation of the Narasimham Committee. The Committee recommended to provide RBI support to market through liquidity adjustment facility involving periodic/daily resetting of Repo and Reverse Repo Rates. The RBI introduced Interim Liquidity Adjustment Facility (ILAF) in place of the General Refinance Facility (GRF). It was thought at that time that pending the upgradation of technology and procedural changes required to switch over to a system of electronic transfer and settlement, ILAF through repos and lending against collateral of Government of India securities would serve as a interim arrangement until the transition to a full fledged Liquidity Adjustment facility is made. The facility enables the Reserve Bank of India to inject liquidity into the market at various interest rates and absorb it, when it becomes necessary, at the fixed repo rate so that it can promote stability of interest rates in the money market. "Interest rates in the credit market reflected the trends in the government securities and money markets. The credit market rates moved in line with the funds position, which was generally easy owing to sluggish growth in demand for credit. As regards the short end of the market, repo rate and the Bank Rate are now perceived by the markets as signals for movements in interest rates, particularly the call money rates. The ILAF has also helped in keeping the money market interest rates range – bound. The significant improvement in liquidity conditions during the current financial year (1999-2000) has averted upward pressure on interest rates".[17]

In a similar way, the interest rates have been practically decontrolled and the interest rates on government securities have come to be determined by the market on the basis of periodic auctions conducted by the Reserve Bank of India. This move to market determined interest rates for the government securities was an important step in creating a broad based market for government debt.

To improve the working of the commercial banks and to make their operations more transparent and profitable, the prudential norms and standards with respect to capital adequacy, income recognition, asset classification, and provisioning have been upgraded and brought into closer alignment with the Basle Committee recommendations. The second Narasimham Committee recommended further lightening of these norms. Again the external supervision of the banks was strengthened to monitor and

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[17] Government of India, Economic Survey, 1999-2000 Page 49.

evaluate the working of the commercial banks with respect to the new prudential standards. The commercial banks could make rapid strides in reducing their net non performing assets (NPAs) considerably. The NPAs of the public sector banks as a proportion of their advances declined from 16.3% at the end of March 1993 to 8.2% at the end of March 1998 and further to 2.9% at the end of March 2000. The second Narasimham Committee had recommended to reduce Net NPAs of the scheduled commercial banks to 3% of their total advances by March 2002.

To make the banking business more competitive, the private sector banks were allowed to be established and the foreign banks are allowed to expand more liberally than in the past. The share of business of private sector banks and foreign banks has increased from about 10.6% in 1991-92 to 17.6% in 1996-97 and it further increased to about 20% in 1999-2000. While the public sector banks still dominated the banking system of the Indian Economy by March 2000, greater competition between public sector banks on the one hand and the private commercial banks and the foreign banks on the other had made its impact on their working.

While the public sector banks have made considerable progress in meeting the prudential norms, these norms will have to be further tightened so that they are fully aligned with the best of the international practices in this respect. A liberalized and more open economy with free flow of capital would place heavy demands on India's banking system. Bank margins would come under pressure as higher quality borrowers would gain access to financial markets outside the economy. Moreover, the commercial banks will have to develop more comprehensive credit appraisal skills than in the past to be able to assess the loan applications under more competitive environment with inherently higher risk of failure. Again, the Indian economy, getting more integrated with the world economy, would involve exposure to greater volatility in foreign exchange rates and interest rates and the credit appraisal techniques must take account of the possibility of uncertainties on the quality of loan portfolio.

Another important aspect of banking reforms in India is related to the ownership and management of commercial banks. While most of the public sector commercial banks have brought down the share of the government ownership in their equity capital to less than 100%, it is still higher than 51%. On the lines proposed in the Union Budget for 2000-2001, the government introduced the Banking Companies (Acquisition and Transfer of Undertakings) and Financial Institutions Laws (Amendment) Bill, 2000 in parliament which sought to reduce the minimum shareholding by government in the nationalized banks to 33% to enable them to raise fresh equity from the capital market. However, this bill could not be passed because of diverse opinion on the subject. Similarly weak public sector banks could not be merged with other sound public sector banks or private sector banks. There are, however, a few cases of merger among the private sector banks.

Capital Market Reforms :

Far reaching changes have been introduced in the working of the capital market. The Securities and Exchange Board of India (SEBI) was given statutory powers in1992 and it laid down the statutory regulatory framework governing various participants in the capital market, including rules for insider trading, management of mutual funds, etc. The companies entering the capital market with its Initial Public Offer (IPO) or Rights issue have to make many disclosures about the issue and these rules are further tightened on the basis of experience to protect and promote the interest of the small investors. For example, in 1997-98, appointment of Registrar to an issue for the rights issue was made mandatory. Similarly, with a view to facilitating raising of funds by the infrastructure projects, SEBI allowed debt instruments to be listed on the stock exchanges without prior listing of equity. Again, only corporate bodies are allowed to function as Merchant Bankers.

Another significant change was introduced by modernizing the technology of trading. The National Stock Exchange introduced on line electronic trading in 1994 and the trading system started allowing brokers in large number of cities and towns all over the country to trade in a single unified market through terminals linked to NSE and BSE computes. Similarly, the settlement system has undergone a qualitative improvement. Before 1995-96, completion of a transaction in the share market involved physical transfer of share certificates from the seller to the buyer, followed by submission of the share certificates to company registrars to introduce appropriate change in the register of shareholders. The whole process involved large delays for the shareholders and felt further harassed when the share certificates were lost in transit or were sent back to the seller on the ground that the signature differed. In 1996, a National Depository began to offer the facility to the shareholders of holding securities in dematerilised form and settling transactions through book entries in the depository, eliminating delays and uncertainties in the transfer of ownership.

Foreign Trade and Foreign Exchange Rate Policies – Post Reform Period :

One of the crucial objectives of the structural adjustment programme was to integrate the Indian economy to the world economy by adopting and implementing economic measures to expand foreign trade and to increase the flow of the foreign investment. While there was wide spread consensus across the political spectrum to reduce controls on the domestic industries, it was difficult to achieve such consensus on the subject of external liberalization. As the levels of high protective import duties came down, and the pressure of competition from cheaper imports increased, concern and dissent began to be strongly expressed regarding the need to provide an adequate transition period for the domestic industries to adjust to the external liberalization. This was sometimes expressed in the form of a need to provide a level playing field by first allowing the domestic firms to acquire competitive strength by benefiting from the reduction in domestic policy constraints and then to put them in competition with the foreign firms. This has also been expressed as a problem of sequencing in which it has been argued that the domestic liberalization must precede the external liberalization. Over a period of time, a broad consensus could be evolved in favour of a gradual and not sudden and rapid, transition to the process of external liberalization. Since 1994-95, considerable progress could be made by removing quantitative restrictions on imports as well as lowering tariff rates.

The cumulative effect of the measures taken to move to a market determined managed floating rate system was that between June 1991 and March 1993, India's foreign exchange rate depreciated from \$ 1 = Rs.20 to \$ 1 = Rs. 31 which meant 35% depreciation of the rupee in the Dollar value. This adjustment in the foreign exchange rate helped the Indian industries considerably to face the increased import competition arising out of trade liberalization.

The Indian economy continued with the managed floating rate regime with the foreign exchange rate responding to the market forces of demand for and supply of foreign exchange with the intervention from the RBI, when required, to maintain a stable and orderly market conditions. Serious speculative pressure on the Indian rupee was built in the wake of the South East Asian financial and currency crisis during 1997-98. However, with help of the appropriate monetary measures and the effective intervention in the foreign exchange market, the RBI could succeed in avoiding the panic situation in the market without undue depreciation of the rupee. While the South East Asian currencies on an average declined by almost 50% against the Dollar within a short span of 6 to 8 months during 1997-98, the fall in the value of the rupee was much less, resulting into the appreciation of the rupee against these Asian Currencies leading to an adverse impact on the performance of exports.

Qualitative Restrictions :

By 1993, import licensing was almost abolished for the imports of industrial raw materials, intermediates and capital goods. In other words, the imports under these categories could be made freely, subject only to the prevailing import duties, whose level was also brought down year after year. However, agricultural products and industrial consumer goods remained under quantitative restrictions. Import restrictions on agriculture were probably redundant as India's agricultural commodity prices were lower than the import prices and the agricultural sector actually suffered from negative protection due to export controls. On the other hand, quantitative restrictions on the imports of consumer goods provided very high open ended protection for all industrial consumer goods. As long as India had continuous balance of payments deficit year after year, the trading partners of India did not raise serious objection against quantitative restrictions on imports of these items. However, as the balance of payments situation improved, continuance of quantitative restrictions was opposed by the major trading partners of India as inconsistent with the provisions of WTO agreement. The Government made an announcement in1998 that all quantitative restrictions would be gradually phased out within a period of six years. This agreement was acceptable to all major trading partners of India except the USA. The Government removed quantitative restrictions (QRs) on 350 items in April 1998, the Government removed unilaterally QRs on 2000 items out of these 2200 items for the imports coming from the SAARC countries with the objective of encouraging trade liberalization in this region. The Government abolished QRs on imports in a phased manner, instead of in six years, in the next three years. By January 2001, all quantitative restrictions on imports were removed.

Foreign Investment Policy :

One of the crucial components of the structural reforms policy was to provide a radical reorientation to the foreign investment policy. Right from the days India became independent in 1947, its economic policy consisted of a hostile attitude towards foreign capital and its inflow was positively discouraged. It depended on external debt creating capital flows, mostly from the multilateral financial institutions to meet its persistent deficit on the current account of the balance of payments. After 1991, foreign investment was actively sought not only as a preferred means of financing balance of payments deficits but also because it provided an access to the much needed foreign technology and equally needed global marketing linkages.

While liberalising capital inflows in the form of foreign direct investment and portfolio investment, other elements of the capital account remained subject to controls by the Reserve Bank of India. The private sector companies and individuals required explicit permission to borrow abroad which could be granted within a framework which placed an upper limit on total external borrowing and could also ensure a minimum maturity period in each case of such borrowing. This policy helped India to avoid an earlier mistake of short term borrowing on a large scale during the second half of 1980s and that policy suffered from a serious weakness that it becomes difficult to recycle it once the confidence in The Country's ability to honour its external commitment is questioned by the lenders. The new orientation given to the policy of external borrowing helped control India's exposure to external debt and in particular to avoid a build up of short term debt which had fallen into disfavour after the world economy was shaken by the catastrophic Asian Development crisis of 1997-98. While the foreign investors – corporations and mutual funds – were allowed to repatriate dividends, interest and even capital freely, Indian companies and residents were not free to take capital out of the country with a view to avoiding a possible panic fuelled overreaction in the international financial markets.

The Reserve Bank of India appointed in 1996 a committee on capital account convertibility to advise on moving towards a full convertibility on capital account. The committee studied the whole question at great length, as the IMF, before the South East Asian economies were hit by the financial crisis among quite a few factors, largely by the serious weakness of their financial system, strongly recommended a transition to the full convertibility of the currency on the capital account. The committee did not recommend a hasty move towards it. On the contrary, it very rightly recommended the transition to capital account convertibility in a phased manner and emphasized that certain important preconditions must be satisfied first. These preconditions included a moderation in the rate of inflation, a reduction in the fiscal deficit as a percentage of GDP to 3% and strengthening of the domestic financial system to be able to deal with confidence, stresses that might be created by the full capital account convertibility.

Private Investment :

The industrial environment in the Indian economy before 1991 was characterized by comprehensive government controls on private investment as a result of which the private sector industries could not respond quickly to various market signals. There were some attempts at liberalization after 1981 which got further momentum after 1984. However, these changes in the industrial policy touched only the periphery of the industrial sector and the broad controls remained unchanged. Reducing these restrictions and controls was critical to create a more competitive industrial environment and this part of the reform agenda broadly described as domestic liberalization has enjoyed widespread political support. As a result of such support, major progress could be achieved in this area of economic reform and the domestic industrial sector could be made free from large number of controls.

Industrial licensing was by far the most powerful instrument of control under which it was stipulated that the permission of the central government was required for setting up a new unit as well as for undertaking substantial expansion of capacity by the existing units. It came to be widely observed that this policy was responsible for many of the evils that afflicted the private sector industries in India. "Industry licensing reduced competition by acting as a barrier for new entry ostensibly to avoid emergence of wasteful surplus capacity. It encouraged the establishment of small sub optimal scale plants partly in order to encourage a broader spread of entrepreneurship. The system was often used to push new units into backward areas in the hope of promoting regional equity. The system also discouraged systematic project evaluation by banks and financial institutions by creating a presumption in favour of supporting projects which had received licensing approval from the government. The inefficiencies generated by the system in turn became the excuse to seek tailor made protection through protective trade policies".[18]

Before 1991, large number of industries were reserved for the public sector. This policy was changed and licensing was abolished for all industries except six which were alcoholic beverages, cigars and cigarettes, defence products, hazardous chemicals, electronics and pharmaceuticals. Similarly MRTP act was also abolished, which worked as an instrument to

[18] Montek S Ahluwalia, "India's Economic Reforms : An Appraisal" Page 43 and 44, In Sachs Jeffery D, Varshney Ashutosh and Bajpai Nirupam (eds.) India in the era of economic reform, Oxford University Press, 1999.

restrict entry. Before 1991, eighteen industries – basic and capital intensive in nature like heavy machinery, iron and steel, mineral oil etc. were reserved exclusively for the public sectors. With the structural reform measures, private investment by the Indian companies as well as foreign investment has been permitted into these key industries. This has encouraged in later years massive flow of capital both domestic and foreign into these industries, contributing to the rapid industrial expansion in the Indian economy.

In the industrial sector right from 1956 when the industrial policy resolution was passed and as a result of which, commanding heights of the economy were reserved for the public sector, there was also a policy of reservation for the small scale and the cottage industries. These industries got protection from the domestic large scale industries which were not permitted to produce goods reserved for the cottage and the small scale industries which were defined on the basis of a certain volume of investment in plant and machinery and whose development was given a special boost by adoption a policy of establishing industrial estates providing land, water, roads, electricity, as well as loans from the commercial banks on concessional terms. In 1997, the government attempted to correct its policy by raising the limit of investment from Rs. 60 lakhs to Rs. 3 crores and removed 65 items from the long list of reserved items. In 1998, it was decided to drop the farm implements from the reservation list. There are some products like the shoes and leather products, toys and garments, which have large export potential, and the small scale units are not in a position to exploit it, in view of their size and technology level. In 1997, the government decided to allow larger manufacturing units in the private sector to enter into these areas provided they accepted the responsibility to export 50% of their production.

In the field of liberalizing various aspects of industrial policy, very little progress could be achieved at the state level. The business firms desirous of starting new units have to secure large number of permissions from the respective state governments regarding purchase of land, securing water and electricity connections and so on. There is a wide spread complaint that obtaining such permission involve avoidable harassment and delay. As the competition among the state governments has become keener, with the progress of the structural reforms to attract domestic and foreign investment, the rigour of such evils is likely to go down rapidly.

We will now look at the results that these reform measures produced on the Indian Economy between 1994-95 1999-2000.

Table : VI.9 – Key Indicators[19]

	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000
	(% Change over previous year)					
Gross domestic product	7.8	7.2	7.5	5.0	6.5	6.1
Agricultural Production	5.2	-2.7	9.3	-6.1	6.5	7.3
Industrial Production	9.4	12.1	5.6	6.6	4.1	6.7
Wholesale price index	10.4	5.0	6.9	5.3	5.3	6.5
Consumer Price Index for Industrial Workers	9.7	8.9	10.0	8.3	8.9	4.8
Money Supply (M_3)	22.3	13.7	16.2	18.0	19.4	14.6
Imports at Current Prices (US $)	22.9	28.0	6.7	6.0	2.2	11.4
Exports at current prices (US $)	18.4	20.7	5.3	4.6	7.4	16.6
Foreign Currency Assets (US $ million)	20809	17044	22367	25975	29522	35058
Exchange Rate (Rs / US $)	31.40	33.45	35.50	37.16	42.07	43.33
External Debt ($ Billion)	99	93.73	93.47	93.53	97.68	98.44
Debt Service Ratio (% of Exports)	26.3	26.7	26.8	27.6	18.0	16.2

GDP increased at an average rate of 7.5% during 1994-95 to 1996-97. However, it slowed down to 5.1%in 1997-98. Inspite of this slow down in the growth rate during 1997-98, the average rate of growth during these four years – 1994-95 to 1997-98 was 6.9%, which was considerably higher than the growth rate during the pre reform decade of 1980s when it was 5.6%.

[19] Government of India, Economic Survey 1997-98 page 2 for the statistical information for the years 1994-95, and 1995-96 and Economic Survey 1999-2000 and 2000-2001 for the years 1996-97 to 1999-2000.

We can also look at if from another angle. The growth rate achieved during the eighth plan period 1992-93 to 1996-97 was, on an average 6.8%, which was higher than the target of 6.5%. In the last two years of the decade of 1990s, the Indian economy failed to reach the high growth rate that it could achieve during 1994-95 to 1996-97. During these six years, agricultural production growth rate turned negative for two years 1995-96 and 1997-98, while it was quite satisfactory in the remaining four years. Industrial production increased in a robust manner during 1994-95 and 1995-96 at the rate of 9.4% and 12.1% respectively reflecting lot of optimism in the economy resulting from the reduction in the restrictive regime that it experienced for almost 40 years since 1956. However, this momentum could not be maintained in the next four years when it increased at an average rate of a little over 5%. The slow down in the industrial sector was partly attributed to mining and electricity generation sectors which recorded insignificant growth. "Deceleration in industrial growth could be attributed to several factors. One of the most important is the decline in investment as shown by the decline in capital goods production and the fall in the value of imports of capital goods during 1997-98. Among the reasons for reduced investment are domestic and international uncertainty and reduced confidence and a somewhat lacklusture capital market which made it difficult to raise equity. Other factors constraining industrial expansion were the sharp decline in growth of exports since 1996-97 and the persistence of high real interest rates".[20]

Apart from this, industrial sector growth was adversely affected by the severe financial and currency crisis that the South East Asian countries experienced, imposing large depreciation of their currencies, adversely affecting exports of the Indian economy. The crisis also created uncertainty in India regarding the stability of its exchange rate. This problem got further compounded by the atomic test explosion in 1998 as a result of which number of sanctions were placed on the Indian economy, adversely affecting its foreign trade as well as inflow of capital.

The rate of inflation measured in terms of wholesale price index, having reached a high level of 10.4% in 1994-95, remained quite low in the next five years. However, consumer price inflation remained at high level for most of the years during this period. Exports and imports both increased quite vigorously during the first two years responding favourbly to the outward looking foreign trade policy as well as appropriately framed foreign exchange rate policy. However, growth rates of exports and imports came down considerably under the impact of currency crisis in the South East Asian countries and the sanctions placed on India in the wake of its nuclear explosion. In 1994, India's foreign exchange rate was $ 1 = Rs. 31.40. The Indian rupee went on falling against the US Dollar and other major currencies of the world as it continued to have a continuous deficit both on

[20] Government of India, Economic Survey 1997-98, Page 5.

its balance of trade and current account of the balance of payments. The foreign exchange rate has fallen after six years at the end of 1999-2000 to $ 1 = Rs. 43.33 – decline of 40% during this period. It was during the difficult period of two years – 1997-98 and 1998-99 that the Indian rupee fell by a large amount. This was the turbulent period of two years during which not only currencies of the four South East Asian countries, but currencies of number of countries across the World such as Korea, Russia, Argentina etc. suffered very heavy depreciation. On the whole, the Indian economy withstood this currency crisis quite satisfactorily largely because of the strengthening of its financial sector – most importantly the commercial banks – that had started correcting their working under the prudential norms as recommended by the first and the second Narasimham Committee. While the number of countries adversely affected by the currency crisis of 1997-98 lost substantial part of their substantial foreign exchange reserves during the first few months, the Indian economy could keep on adding to its reserves – which were about $ 21 billion on 1994-95, rose to about $ 26 billion in 1997-98 and stood at $ 35 billion in 1999-2000, registering an increase of almost 66% during these six years. Its external debt almost remained at the same level while its debt service ratio which was 26.3% in 1994-95, and which remained more or less at the same level, came down steeply to 18% and 16.2% during the last two years – 1998-99 and 1999-2000 respectively. "After exhibiting relative stability, the Indian rupee, in August 1997, experienced a mild attack of contagion emanating from currency turmoil in

East Asian. Beginning in the second week of November 1997, the exchange rate of the rupee against the US Dollar came under renewed downward pressure. The rupee depreciated to a low of Rs. 40.36 per US Dollar by January 16, 1998, but recovered to Rs. 39.49 on March 10, 1998. The rupee Dollar rate came under downward pressure in May 1998 and again in July 1998, following uncertainty arising from economic sanctions imposed on India, the down grading of India's investment rating by international investment rating agencies and continued turbulence in international financial markets. Since September 1998, the rupee displayed reasonable stability upto end of March 1999. From April onwards, the exchange rate had been reacting to the uncertainty linked to political developments, followed by the Kargil episode. Against this backdrop, by end of September 1999, the rate had reached Rs. 43.60 per US Dollar as compared with Rs. 42.51 per Dollar on April 6, 1999. However, since October 1999 the exchange rate has displayed reasonable stability and at the end of January 2000, the rate was Rs. 43.64 per US Dollar".[21]

The improvement that the Indian economy registered in the external trade sector during the three years of the economic stabilization period 1991-92 to 1993-94 was continued with vigour in the next years 1994-95 to 1999-2000 when structural reforms were undertaken to put the economy on the path of high sustainable growth rate. The following table provides relevant information on this subject.

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[21] Govt. of India, Economic Survey 1999-2000 Page 109.

Table : VI.10 – Selected indicates for the External Sector[22]

(As per cent of GDP)

	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000
Exports	8.3	9.1	8.9	8.7	8.3	8.4
Imports	11.1	12.3	12.7	12.5	11.5	12.4
Trade Balance	-2.8	-3.2	-3.8	-3.8	-3.2	-4.0
Invisible Balance	1.8	1.6	2.7	2.4	2.2	3.0
Current Account Balance	-1.0	-1.7	-1.2	-1.4	-1.0	-1.1
External Debt	30.8	27.0	24.5	24.3	23.6	22.2
Debt service payment	3.4	3.4	3.2	2.7	2.6	2.5

India's exports which were 5.8% of GDP in 1990-91 have gone up considerably and in no year between 1994-95 to 1999-2000, fell below 8%. Similarly, its imports which were 8.8% of GDP in 1990-91 have also stabilized at a significantly higher level and in no year, came down below 11%. Thus, India's exports plus imports that constituted about 14% of GDP during all years during this period, indicating continuously increasing integration the Indian economy into the world economy. While the deficit in the balance of trade as percentage of GDP increased from 2.8% in 1994-95 to 4% in 1999-2000, the deficit in the current account of the balance of payments moved between 1% to 1.7% during this period. The significant contribution in stabilizing the current account balance was made by the invisible balance which increased from 1.6% of GDP in 1995-96 to 3% of GDP in 1999-2000. This growth in the invisible receipts could be attributed

[22] Government of India, Economic Survey 2001-2002 Page 134

to the buoyant situation made possible by private transfers and software service exports. India's external debt as a percentage of GDP went on declining from 30.8% in 1994-95 to 22.2% in 1999-2000. Similarly there was a favourable trend in the debt service payments as a percentage of GDP that came down by almost 1% between 1994-95 and 1999-2000.

Exports as a percent of imports, were 66.2% in 1990-91. In 1994-95, it had gone up to 74.8% and in 1999-2000, it came down to 67.8%. In the intervening years, it moved around 70%. Where significant improvement is witnessed is the import cover of foreign exchange reserves, that is to say, the import bill of number of months that our foreign exchange reserves can meet. In 1990-91 our foreign exchange reserves were enough to pay for two and a half months imports. In 1994-95, our foreign exchange reserves were large enough to cover 8.4 months import bill and having come down to 6 months cover, it again increased to 8.2 months cover by 1999-2000, showing considerable improvement in the balance of payments situation. since the reforms started in 1991-92. The external assistance that we received from the multilateral financial institutions accounted for almost 25% of the total capital flow into India in 1990-91. The importance of this source has clearly gone down after 1994-95, though it played a critical role in assisting the Indian economy in tiding over the severe foreign exchange reserves crisis during 1991-92 to 1993-94. While we continue to receive financial assistance from these institutions and some loans from the World Bank are given to India at very concessional rate of interest and for a considerably long period, the relative importance of this source has been gradually declining and stood at about 8% in 1999-2000 – one third of what it was ten years ago. With the inflow of foreign capital in the form of FDI and portfolio investment growing at a faster rate since the beginning of the reforms in 1991-92, all debt creating inflow of capital have fallen in relative importance. Another favourable development could be observed in case of short term debt whose relatively large proportion in India's total debt and India's inability to recycle it as its balance of payments situation went on deteriorating after 1987-88. In 1990-91, short term debt as a percentage of India's foreign exchange reserves was 146.5 which was quite high and unsustainable. It has gradually comedown to 10.3% in 1999-2000.[23]

Foreign investment creating non debt capital inflow was quite insignificant in 1990-91 when debt creating capital inflow in the form of external assistance, commercial borrowing and NRI deposits were relatively more important. The relevant information is provided in the following table.

[23] Government of India, Economic Survey 2001-02 Pate 134.

Table : VI.11 – Balance of Payments : Summary[24]

(In US $ million)

	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000
Trade balance	-9049	-11359	-14815	-15507	-13246	-17841
Invisibles (net)	5680	5449	10196	10007	9208	13143
Current Account balance	-3369	-5910	-4619	-5500	-4038	-4698
External Assistance (net)	1526	883	1109	907	820	901
Commercial Borrowing (net)	1030	1275	2848	3999	4362	313
IMF (Net)	-1143	-1715	-975	-618	-393	-260
NRI Deposits (net)	172	1103	3350	1125	960	1540
Foreign investment (net)	4807	4615	5963	5353	2312	5117
Of which						
(i) FDI	1228	1954	2651	3525	2380	2093
(ii) FII	1503	2009	1926	979	-390	2135
(iii) Euro equities & others	2076	652	1386	849	322	889
Other flows (net)	2604	-2235	-1131	-6006	6008	3940
Capital account total	8013	2974	10437	9393	7867	10840
Reserve use (- decrease / + increase)	-4644	2936	-5818	-3893	-3829	-6142

In 1990-91, India had very high current account deficit, which was the outcome of very high trade balance and even negative invisible balance. All receipts on capital account such as external assistance, commercial borrowing IMF assistance and negligible private foreign investment amounted to $ 8402 million, requiring India to use its foreign exchange reserves by $ 1300 million, precipitating the balance of payments crisis in

[24] Ibid Page 133

the next few months. There was a qualitative change in the balance of payments components from the very next year and this change became quite marked form 1994-95. While the deficit in the balance of trade went on increasing from about $ 9 billion in 1994-95 to about $ 18 billion in 1999-2000 – it practically doubled within a short span of six years – the invisible receipts increased from about $ 6 billion in 1994-95 to $ 13 billion in 1999-2000 – it more than doubled during the same period, with the result that the deficit in the current account of the balance of payments which was as high as $ 9.7 billion in 1990-91, was practically half of this level in each year between 1994-95 to 1999-2000, reflecting a qualitative improvement in India's balance of payments. In 1990-91 out of the total receipts on capital account of about $ 8.4 billion, practically whole of it was obtained through borrowing from one source or another i.e. through debt creating capital inflows adding to the external debt year after year. Private foreign investment in the form of FDI and FIIs bought insignificant portion of the total capital receipts required to meet the deficit in the current account. This picture had changed qualitatively by 1994-95. The flow of assistance from the IMF turned negative for all the six years from 1994-95 to 1999-2000 indicating that the repayment commitments in the form of loan installment and interest payments were in excess of gross financial assistance sanctioned. This negative flow of capital towards IMF was quite sizable during 1994-95 and 1995-96 amounting to $ 1.1 billion and $ 1.7 billion respectively, becoming smaller year after year later on. What is even more striking was that for the year 1994-95, the deficit in the current account was $ 3.4 billion while capital receipts from private flow of foreign investment was $ 4.8 billion, enough to meet the deficit and the surplus of $ 1.4 billion was available for the addition to the foreign exchange reserves of India. The flow of capital under private foreign investment for all the years upto 1999-2000 was almost $ 5 billion, which was in excess of deficit in the current account for the year 1994-95, 1997-98 and 1999-2000. There was a sharp decline in the flow of private foreign capital during 1998-99 when it was almost half of what it was in other five years. This was as a result of currency crisis in East Asia, Kargil war, adverse impact of nuclear explosion and fall in the investment rating of India by the international rating agencies. However, the adverse impact was short lived and the trend of receiving about $ 5 billion inflow of private foreign capital was restored in the next year 1999-2000. Flow of private foreign capital under FDI was of the order of about $ 2 billion per year, while that under the category of FIIs was slightly smaller, indicating the interest of the foreign business firms in making long term investment in India. The portfolio investment turned negative during the year 1998-99 because of certain adverse factors. Indian firms could raise about $ 2 billion through the GDR issues during the year 1994-95, but for the remaining five years, it was less than $ 1 billion. During 1994-95 and 1995-96, large investment was planned by the domestic and foreign firms and there was a wave of optimism which petered off in the remaining four years of the decade because of political uncertainty arising out of mid term elections and the economic sanctions imposed by the UN in the wake of the nuclear explosion in mid 1998. And yet, the Indian economy could add to its foreign exchange reserves for all these six years – adding almost $ 27 billion, a large part of it was contributed by the non-debt creating capital flows. While such capital flows do not require the government to pay interest and dividend to the rest of the world, it would nonetheless imply that the private corporate sector as well as the foreign firms would be required to pay these claims out of their profit. The portfolio investment is meant for the equity and the debt market and would remain as long as it could be invested in a profitable manner. Such capital funds are usually described as short term and footloose and if not regulated effectively, can tend to destabilize the financial markets of any economy.

By 1999, India's external debt was $ 94 billion and ranked tenth in terms of the size of its external debt, nine countries such as Brazil, Russian Federation, Mexico, China, Indonesia, Argentina, Korea, Turkey each having external debt of more than $ 100 billion and Thailand with $ 96 billion. Among these ten countries, India's external debt to GNP ratio was 21. China's ratio was 16. All other 13 countries were having much higher debt to GNP ratio. In fact all the four economies of the South East Asian region had much higher debt to GNP ratio – Indonesia with its total external debt of $ 150 billion had debt – GNP ratio of 113 followed by Thailand, having external debt of $ 96 billion and debt GNP ratio of 80. Philippines had lower amount of external debt of $ 52 billion and debt – GNP ratio of

65. Malaysia had still smaller amount of external debt $ 46 billion and debt – GNP ratio of 63. These four economies were quite deep in their indebtedness. Perhaps the year 1999 was quite close to 1997-98 in which year the severe financial and currency crisis shattered these economies totally and their external debt especially to the multilateral financial institutions had increased because private foreign capital was withdrawn from these economies under unfavourable conditions. Their GDP growth had also considerably slowed down, making the external debt – GNP ratio quite high and unsustainable.[25]

"India's indebtedness position vis-à-vis other emerging economies has improved over the years. In terms of absolute level of debt, India's position improved from the third largest debtor after Brazil and Mexico in 1991 to tenth in 1999 after Brazil, Russian federation ..... Thailand. In terms of present value (PV) of external debt, India also ranks as the tenth largest debtor country. In terms of indebtedness classification, India improved its position from close to severely indebted category in 1991 to less indebted, bench mark in 1999.[26]

Fiscal Position :

While the precarious balance of payments situation and rapid loss of foreign exchange reserves were the most proximate causes of the economic crisis in 1990-91, deteriorating fiscal position of the centre and the states was also an important contributory factor. In 1990-91 revenue deficit,

[25] Ibid Page 159.
[26] Ibid Page 159.

primary deficit and fiscal deficit as percent of GDP were 3.3%, 2.8% and 6.6% respectively. If we add the combined fiscal deficit of the states, the total fiscal deficit at a little more than 10% was quite large and unsustainable.

While the revenue deficit, primary deficit and fiscal deficit declined during 1991-92 and 1992-93, they again increased and reached more or less the pre reform level.[27] From 1994-95 to 1999-2000, revenue deficit continued to be as large as it was in 1990-91 in fact, it was marginally higher – the fiscal deficit was certainly smaller, one percent point smaller than what it was in 1990-91. High revenue deficit went on adding to the government borrowing year after year and to its internal debt. To tackle this problem with a durable solution, the government of India constituted the committee on Fiscal Responsibility Legislation in January 2000. The committee was to look into various aspects of India's fiscal system and to recommend a draft legislation on fiscal responsibility. On the basis of its recommendations, the Fiscal Responsibility and Budget Management Bill, 2000 was introduced in Lok Sabha in December 2000. The Bill proposed elimination of revenue deficit and progressive reduction of the fiscal deficit to not more than 2% of GDP within a period of five financial years following the promulgation of the law. By March 2009, the revenue deficit of the Central Government would be brought down to zero and the fiscal deficit to 2% of GDP, imparting lot of discipline and stability to the fiscal system.

[27] Ibid Page 42.

The seriousness of the problem of internal debt can be appreciated from the simple fact that the internal debt of the Central Government was 1,54,004 crores in 1990-91 and almost increased by four and a half times to Rs. 7,14,254 crores in 1999-2000. As against this, external debt (outstanding) was Rs. 31,525 crores in 1990-91 and reached Rs. 58,437 crores in 1999-2000 an increase of about 80%. Internal liabilities were 49.8% of GDP in 1990-91 and it remained in percentage terms at the same level -49.9% - in 1999-2000.[28] On the other hand, external debt constituted 5.5% of GDP in 1990-91 and had come down to 3% in 1999-2000. Under the economic reforms programme, while the external debt problem has ceased to be a serious issue, because of large non-debt creating capital flows, the internal debt position continued to be serious because of persistent revenue deficit and the persistent borrowing by the Central Government. We can appreciate the seriousness of the internal debt problem from another set of figures. Interest payment on public debt by the Central Government stood at Rs. 21498 crores in 1990-91 which reached Rs. 90249 crores in 1999-2000. Similarly revenue expenditure in 1990-91 was 12.9% of GDP while interest payment, an important part of the revenue expenditure, was 3.8% of GDP – almost 30% of the revenue expenditure. In 1999-2000, revenue expenditure had remained at the same level -12.9% of GDP but interest payment on public debt had gone up to 4.7% of GDP – almost 40% of the revenue expenditure. Thus, in the first ten years of the economic reforms programme, very little progress could be achieved in strengthening the fiscal

[28] Ibid Page 46.

system of the economy. A crucial step could be taken to strengthen the fiscal system – namely introducing the Fiscal Responsibility and Budget Management Bill in December 2000 which subsequently became an act.

Commenting on the problems that confront macroeconomic policy today and are likely to pose continuing challenges in the years ahead, Dr. Shankar Acharya observed, "First and foremost is the enduring problem of fiscal deficit. As we saw earlier, with a consolidated general government deficit of around 10 percent of GDP, India has the dubious privilege of being in the top three countries in the world wide fiscal deficit rankings. The ratio of Central and state governments debt to GDP also stands impressively high at about 70 percent. Out own economic history and that of many other countries point to the unsustainability of such high ratios and to the enormous economic toll they exact. Furthermore, the problem of debt unsustainability is likely to become, more pressing if the present slowdown in economic growth continues. The sooner there is significant and enduring progress in fiscal consolidation, the better it will be for macroeconomic performance, the health of the financial sector and the economy's capacity for coping with unforeseen external or internal shocks. The best medium term hope in this regard is the Fiscal Responsibility and Budget Management Bill (FRBM) tabled in Parliament in December 2000".[29]

During the first ten years of economic reforms, the Indian economy could complete its economic stabilization programme in a satisfactory manner. It could initiate number of reform measures strengthening its fiscal

[29] Acharya Shankar, India's Macroeconomic Management in the Nineties, 2001 Page 62.

and monetary policies s well as foreign trade policies. Its financial sector could be strengthened and it prevented the contagion from the financial crisis of 1997 spreading to India. It had adopted a system of managed foreign exchange rate under which the foreign exchange rate is allowed to be determined by the market forces of demand and supply with intervention by the Reserve Bank of India, when required to regulate it against unhealthy speculation in the market. The industrial sector is made free from the cumbersome restrictions and it has started responding to the new policies. India's foreign exchange reserves could grow year after year due to non debt creating capital flows in the form of FDI, portfolio investment and GDR issues. Thus those areas of economic policies which are adopted and implemented by the Central Government have made good success. And yet there is a wide spread opinion that after the first few economic reforms, the pace of further reforms has considerably slowed down. "The broad outline of the reforms was not very different from the reforms undertaken by many developing economies in the 1980s, where India's reforms differed was in the much more gradualist pace at which they are implemented. The compulsions of democratic politics in a pluralist society made it necessary to evolve a sufficient consensus across desperate (and often very vocal) interests before policy changes could be implemented and this meant that the pace of reforms was often frustratingly slow".[30]

[30] Ahluwalia Montek S, Ibid. Page 26.

Conclusion :

India could complete the economic stabilization programme during 1991-92 to 1993-94 with spectacular success. Except for the first year 1991-92, when the growth rate was extremely low, all other macroeconomic indicators showed sound progress. The most impressive performance was achieved in the field of balance of payments and foreign exchange reserves – two areas that constituted the proximate causes for the unprecedented crisis in which India found itself in mid-1991. Significant reforms were introduced in the foreign trade policy and the foreign exchange rate policy.

Wide ranging structural adjustment reforms were undertaken from 1994-95 to 1999-2000. While the Indian economy could achieve a high GDP growth rate of 7.5% on an average during three years 1994-95 to 1996-97, it slowed down during 1997-98 and could partly recover in the next two years because of unfavourable external factors such as the financial and currency crisis that hit the South East Asian countries, Cargill war and economic sanctions imposed on India by the U.N. in the wake of the nuclear explosion. Because of the robust increase in the invisible receipts, the current account deficit remained on an average at 1.3% per year and the foreign exchange reserves increased from $ 20 billion in 1994-95 to $ 35 billion in 1999-2000 – an increase of 75% in six years.

The development in the fiscal deficits were not very favourable and the combined fiscal deficit of the Central Government and The State Governments remained at 10% in 1999-2000 where it was six years before.

The adverse impact of the financial burden arising from the implementation of the Fifth Pay Commission in 1998 did not permit much improvement in this area.

While the Central Government could take initiative in adopting wide ranging reforms in major areas of economic policies, the States were lagging behind. This is so because the major areas of economic activities falling in the realm of states are those that directly affect the people – such as agriculture. The states are not willing to undertake major reforms in the fear of losing popular support. However by 1999-2000, the states could realize the need for attracting foreign capital and for providing efficient infrastructure facilities and have started adopting fiscal and industrial policy reforms after 2000.

Exports and imports have shown substantial growth under the structural adjustment programme, taking further the process of globalization. The process of privatization has not made much headway because of opposition from certain political quarters. Foreign banks and foreign insurance companies could not enter the Indian economy on equal terms before 2000 and nationalize banks could not be privatized. Even some of the loss making units in the public sector could not be privatized. Thus, Indian economy could achieve a sound progress in foreign trade sector.