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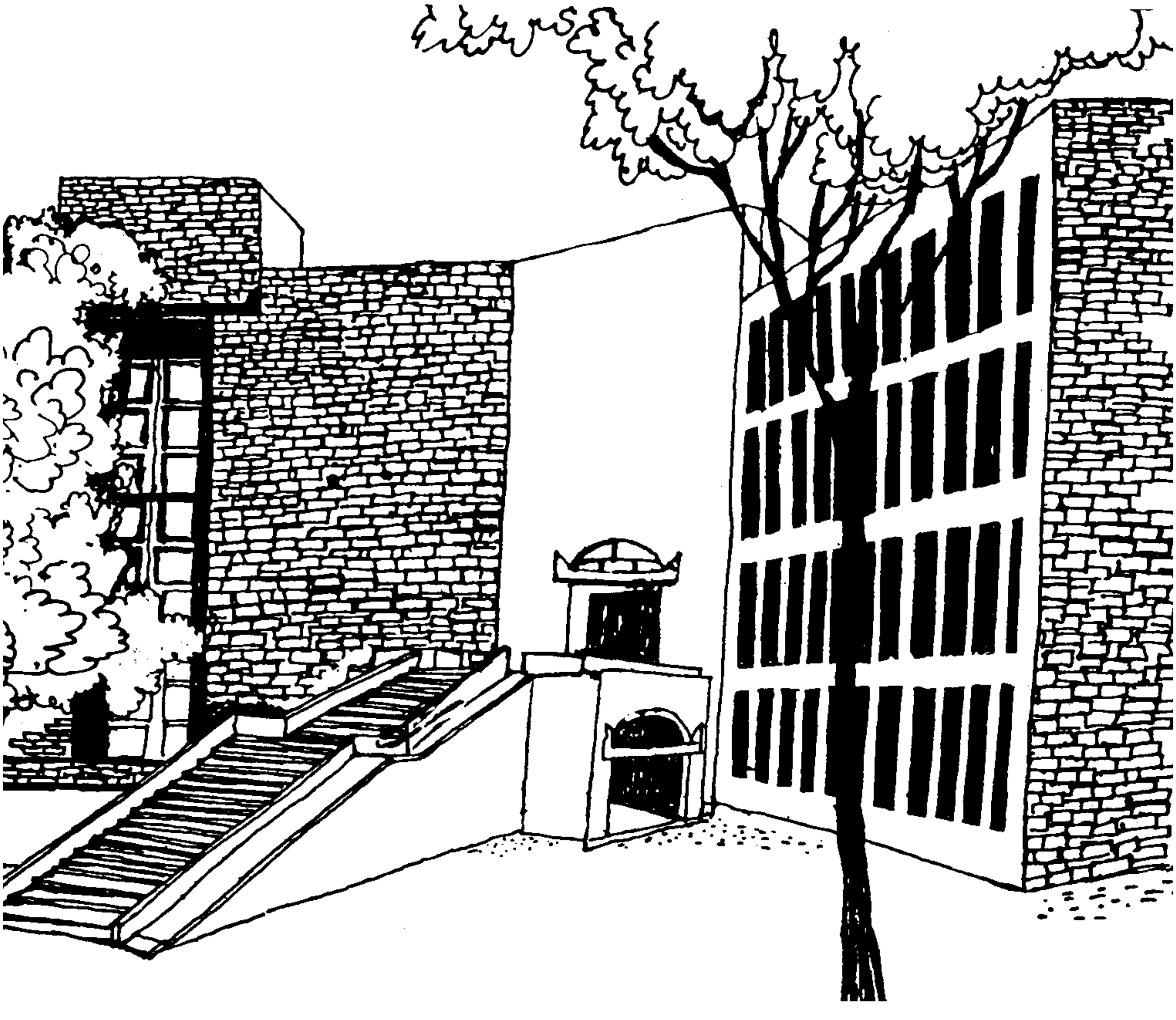

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INDIA'S ECONOMIC CRISIS : NATURE AND REMEDIES

By

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ABSTRACT

Indian economy has been facing a major economic crisis and the situation has become quite serious after August 1990. The main elements of India's economic crisis are deepening foreign exchange crisis, growing fiscal imbalances, increasing rate of inflation, slackening of overall economic growth and deceleration in industrial growth. An attempt has been made in this paper to examine these elements and also analyse India's macroeconomic strengths and weaknesses. The paper also examines critically the policy prescriptions recommended by the group of Left economists to deal with the present economic crisis. The concluding part of the paper presents the author's views on the main ingredients of macroeconomic strategy to deal with the short term as well as long term aspects of present economic crisis.

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1. Introduction

It is now widely recognized that Indian economy has been facing a major economic crisis and especially after August 1990, the gravity of the situation has become more evident than ever before. While the present economic crisis has been the result of a gradual accumulation of the combined effect of various forces operating in the economy during the last decade, its symptoms have become clearly noticeable during the last few months and more particularly after January 1991, when the country's foreign exchange reserves dropped sharply to the lowest level of Rs.1,877 crores, which was barely enough to finance the country's imports for the next 13 days only. It is hardly surprising, therefore, to find that considerable attention is now being focussed on an indepth analysis of India's economic crisis and the alternative courses of policy measures that can be taken to overcome this crisis.

2. Main Elements of Economic Crisis

The major elements of the present economic crisis are : (a) deepening foreign exchange crisis (b) growing fiscal imbalances (c) increasing rate of inflation (d) slackening of overall economic growth and (e) deceleration in industrial growth.

The intensity of the foreign exchange crisis is brought out by the following indicators : (a) There has been a sharp decline in foreign exchange reserves from the level of Rs.8,151 crores in March 1987 to Rs.1,877 crores in early January 1991 (Table 1). While the stand-by IMF loan of Rs.3,275 crores in the third week of January 1991 has temporarily boosted our foreign exchange reserves, the declining trend in the forex reserves has continued unabated during the subsequent period. Thus, the country's foreign exchange reserves have again dropped to the low level of Rs.2,620 crores as of May 17, 1991. (b) Although the country always had a sizeable trade deficit during the eighties, the level of trade deficit has increased sharply during 1990-91 to cross Rs.10,000 crore mark for the first time which is a record in our economic history so far (Table 2). Thus, the average level of trade deficit which used to be around Rs.650 crores per month during 1988-89 and 1989-90 has now increased to around Rs.900 crores per month. At this rate, the stand-by IMF loan availed in January would not last long, even after taking into account small ad hoc loans that we have been able to obtain after January 1991. Hence there is an urgent need to raise enough short-term credit preferably before the end of July. (c) There has been a significant deterioration in India's credit rating especially during the last few months. This has led to a decline in the availability of short-term credit even on relatively more stringent terms and conditions, thereby further accentuating the problem of financing the country's monthly import requirements.

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In September 1990, US credit rating agency Standard and Poor had for the first time placed India at BBB, which is the lowest rung of investment grade in its rating scale. Subsequently, in the last week of March 1991, the Japanese Bond Research Institute (JBRI) as well as Moody's Investors' Service (another major credit rating agency in USA) lowered India's credit ratings to the lowest level in the investment grade, while in the last week of May 1991 Standard and Poor further reduced India's credit rating from the last investment grade level and placed the country in the speculative grade for the first time. If a similar downgrading by JBRI takes place in the near future, it would have very serious implications for India's plans of raising short-term as well as long term loans from the Japanese market. Currently, almost two-thirds of India's total foreign exchange borrowing from the commercial markets is from Japan and the remaining one-third is from the European and American markets. It may be noted that the main reasons given by various credit rating agencies for downgrading India's rating include the impact of the gulf crisis on Indian economy, dwindling foreign exchange reserves, spiralling foreign debt and the relatively long spell of political uncertainties seriously affecting the government's capacity to effectively deal with its external financial obligations. India's foreign debt as of March 1990 has risen to 70 billion US dollars. About $ 4 billion of this amount is fast-revolving short-term debt on which the country is struggling hard at present to avoid default. In fact, the seriousness of the problem is evident from some of the recent actions on India's part like selling 20 tonnes of gold in Zurich during the last week of May 1991 in a desperate bid to raise the steadily declining level of foreign exchange reserves and thereby ensure that the country would be able to meet its debt service obligations without any default at least during the month of June 1991.

A high degree of fiscal imbalance has emerged as another major problem facing Indian economy especially after 1986. The latter half of eighties has been marked not only by high and growing budget deficits, but also by attempts on the part of the government to create a surplus in the capital account to finance its revenue deficit. This unhealthy tendency of borrowing money to finance current consumption expenditure of the government reached an alarming proportion in 1990-91 when the revised estimates of revenue deficit turned out to be Rs.17,585 crores, while the overall budget deficit was reported to be Rs.10,772 crores, indicating a net surplus of Rs.6,813 crores on capital account. Moreover, the fiscal deficit, which represents the actual difference between aggregate government expenditure and current revenue has reached the highest ever level of Rs.43,331 crores in 1990-91 (Table 3). Thus, in the year 1990-91, nearly two-fifths of the revenue deficit has been financed by capital account surplus and the size of overall fiscal deficit has turned out to be as high as 8.6% of GDP.

Other major problems faced by Indian economy especially during the last two years are declining growth rates of GDP as well as industrial production and rising rate of inflation.

Indian economy grew at an average rate of 5.5% per annum during the period 1980 to 1989 as against the average rate of 3.5% per annum during the previous three decades. However, the growth rate of GDP has declined to 4.5% in 1989-90 and it is unlikely to exceed that level during 1990-91. Similarly, the growth rate of industrial production has also declined from 8.8% in 1988-89 to around 7.5% in 1990-91. Moreover, while the average rate of inflation during the period 1980 to 1989 was around 6.4% per annum, it increased sharply to 11.3% during 1990-91. All these factors clearly indicate the deepening economic crisis faced by the country.

Whether the present foreign exchange crisis can be regarded mainly as the short term liquidity problem or it also represents the more serious problem of long term solvency is the critical issue at this juncture. It is evident from an analysis of the nature of economic crisis that the present crisis faced by Indian economy cannot be viewed only as a short-term problem of liquidity. The strategy to deal with the present economic crisis has, therefore, to focus both on the short-term measures to solve the immediate liquidity problem and simultaneously initiate the process of bringing about long-term changes that would effectively eliminate the basic factors contributing to such crisis. The only viable long term strategy to overcome the present economic crisis is to achieve rapid economic growth with exports growing significantly faster than imports and general price level rising very slowly. While this was the characteristic feature of the economy during the latter half of eighties, the trend was suddenly reversed in 1990-91 which saw imports growing far more rapidly than exports coupled with a down turn in overall economic growth and a high rate of inflation.

3. Macroeconomic Strengths and Weaknesses

The silver lining in the dark clouds of deepening economic crisis is represented by the basic strengths acquired by Indian economy during the eighties. Even the severest critics of India's macroeconomic management during the eighties have to admit that the Indian economy has acquired a strong growth orientation and has succeeded in shifting to a higher path of long-term economic growth during this period. Moreover, the economy has developed much greater resilience to weather fluctuations, which has enabled the country to achieve self-sufficiency in foodgrains and also contributed to the building up of adequate buffer stocks of foodgrains. We have also achieved a significant increase in the annual growth rates of exports, especially in the latter part of eighties in relation to the earlier period. By now, we have also built a strong and fairly well diversified industrial base. The climate for industrial investment has improved considerably and especially in the latter part of eighties it has shown a remarkable buoyancy. Given these inherent strengths of the economy, it would be imprudent to have an entirely pessimistic outlook on the country's future.

The major weaknesses of Indian economy, which have emerged during the latter half of eighties, are growing pressure on balance of payments, steadily mounting foreign debt, structural imbalance in the pattern of industrial growth, persistent fiscal imbalance, stagnation in the overall savings rate, continuing pressure on the price level and vulnerability of the economy to external shocks like the Gulf crisis. The Prime Minister's Economic Advisory Council (then chaired by the late Prof. Sukhamoy Chakravarty) had specifically pointed out many of these problem areas in some of its earlier reports prepared during 1987-89. Sharp increase in the intensity of some of these problem areas has actually led to the present economic crisis.

Following the second oil price shock of 1979-80, India's foreign trade deficit increased sharply to 4.4% of GDP in 1980-81. This, coupled with the severe drought of 1979-80, would have led to a major economic crisis in early eighties. However, it could be effectively avoided because of three reasons: (a) There was a reduction in oil imports which was made possible by a significant increase in indigenous oil production from Bombay High; (b) a sizeable proportion of country's trade deficit was offset by increasing levels of private remittances from Indian workers in the oil exporting countries; and (c) the government took recourse to a programme of external commercial borrowing as well as a large Extended Fund Facility (EFF) loan from the IMF to tide over the BOP problems. While these measures could avoid major economic crisis in early eighties, the seeds of the present economic crisis were perhaps sown precisely during that period. That was mainly because our export performance during the Sixth Plan period (1980-1985) was dismal, the average growth rate of export volume being less than 3% per annum. As a result, by 1985-86 the ratio of exports to imports had fallen to the lowest ever level of 54%. As it is now widely recognized, one of the factors contributing to this situation was the conservative exchange rate policy followed during the period 1980-85. During this period, the nominal effective exchange rate declined by just around 20%, while the real effective exchange rate remained almost unchanged (Table 4). Thus, the Indian currency almost maintained its relatively overvalued level during the first half of eighties, and in the process we failed to take advantage of the opportunities for significantly increasing our exports offered by a relatively favourable global economic environment during that period.

In mid-eighties, the country's credit worthiness was rated very highly by international agencies and this facilitated large scale external commercial borrowing to finance country's growing trade deficit. During the period 1980-1989, country's external commercial borrowing (including suppliers credit) increased sharply from Rs.4,146 crores to Rs.17,482 crores. It is only natural that such a phenomenal increase in external borrowing coupled with slow growth of exports during the first half of eighties would lead to a steep increase in relative debt service burden. Thus, the ratio of debt service obligations on medium and long term debt to aggregate current receipts (exports *plus* gross invisible earnings) increased from 9.2% in 1980-81 to around 23% by 1989. Moreover, between the first half of eighties (Sixth Plan period) and the second half of eighties (Seventh Plan period), the pattern of financing the current account deficit changed drastically. In the Sixth Plan period, the current account deficit was financed largely by net capital flows from official agencies such as the World Bank, IMF and bilateral donor agencies. As against this, during the Seventh Plan period, current account deficit was being financed increasingly by funds from commercial sources mainly in the form of external commercial borrowing and non-resident deposits. This shift in the pattern of financing the current account deficit coupled with a significant increase in the level of trade deficit itself led to a sharp deterioration in India's external balance.

It is interesting to note that Chakravarty Committee, which prepared a detailed report on the current economic situation for consideration by the then newly elected National Front Government in December 1989, expressed concern over the deterioration in the country's external balance but it did not envisage the serious crisis that the economy could plunge into in the near future. Thus, Chakravarty Committee felt that, "While rising trends in India's external debt and debt service constitute serious cause for concern, the situation is not one that threatens immediately the solvency or credit worthiness of the country."*[1]. However, Chakravarty Committee report drew specific attention to two crucial factors which have contributed to the mounting pressure on our BOP, viz., (a) the fiscal and trade policy structure which has provided incentives for import intensive industrialisation catering to. the protected domestic markets; and (b) growing average import intensity of aggregate exports on account of a more rapid increase in exports having relatively greater import content. It is argued that both these factors are the result of the policies of economic liberalisation pursued during the eighties.

4. Strategy Based on Leftist View

The strategy to deal with the present economic crisis and to restore the healthy growth of the economy should be derived on the basis of an objective evaluation of the available alternatives in the light of the existing circumstances. However, in practice, macroeconomic strategy formulation invariably gets linked with the political ideologies. A classic example of this is provided by the policy prescriptions suggested by the group of Left Economists in a statement adopted at a recent seminar.*[2] They have recommended that the appropriate

*1. *Report of the Economic Advisory Council On The Current Economic Situation and Priority Areas for Action*, Ministry of Finance, Government of India, December 1989; p. 12.

*2. Seminar on Economic Policies organised by the Left Parties, New Delhi, February 22-24, 1991. The Statement adopted at this Seminar has been published in Mainstream, March 9, 1991 and also in The Business and Political Observer, May 14, 1991.

way of curbing the balance of payments deficit is through direct curbs on imports. Moreover, they argue that the government should not opt for a significant cut in the fiscal deficit because major cuts in fiscal deficits would lead the economy into a deep recession. Thus, according to the group of Left Economists, "Opting solely for a reduction in the fiscal deficit and that too through a cut in capital expenditures, as appears likely under IMF pressure, will not only push the economy into a recession immediately, but also adversely affect future growth prospects. In our view the government should opt for a much smaller cut in the fiscal deficit than the two per cent reportedly suggested by the IMF and actually proposed by the Finance Minister." The main conclusion drawn by the Left Economists from their analysis of the present economic crisis is as follows : "Resort to a second IMF loan is not the only option available to the country. Rather through a combination of a stricter import regime and appropriate budgetary policies, the country can achieve the required balance of payments adjustment, without either generating a recession of the intensity that the IMF package would result in or cutting welfare expenditures."

It appears that there is some confusion here between the short-term and the long-term aspects of the present economic crisis and the remedial action required to tackle it. While policy measures designed to curb imports during the first half of the current financial year (1991-92) as a means to ease short-term liquidity problem are justifiable in terms of sound economic reasoning, permanent use of this method as a long-term solution to the country's balance of payments problem seems absurd especially in the light of the existing economic structure. Today, many of our existing industries are critically dependent on import of raw materials for their regular production. The available information indicates that the list of industries where import content in the raw materials consumed exceeds 25% includes important industries like chemicals, man-made fibres, fertilisers, pharmaceuticals, paints, textiles, cables, paper, mini steel, consumer electronics, gems & jewellery, etc. Some of these industries predominantly cater to the requirements of the common man and some of them are export oriented. Moreover, most of these industries have high growth potential. Hence, permanent curbs on import of raw materials, as suggested by the Leftist view, would retard the long term growth of such industries and seriously affect their capacity utilisation, which would in turn lead to recession coupled with a decline in overall cost efficiency.

Similarly, high level of fiscal deficit arises partly on account of transfer payments to various social groups through open or hidden subsidies. The burden of these subsidies is ultimately borne by the productive sectors of the economy and it finally results in an increased cost in these sectors, which makes their products less competitive abroad and simultaneously restraints the growth of their demand in the domestic market. Moreover, high budget deficits occurring year after year create severe inflationary pressures, which also produce the same effect. Thus, there is an urgent need to reduce the size of fiscal deficit and correct the fiscal imbalance at this juncture and the questioning of this policy prescription by the Leftist view seems to be devoid of any sound economic reasoning. In fact, it is most likely that in the long run the Leftist prescription of import curbs on industrial raw materials and maintenance of high fiscal deficits would adversely affect the growth of industrial production in general and growth of exports in particular. This would in effect worsen the country's balance of payment problem instead of solving it.

The serious concern expressed by Left economists, which is also often shared by others, that the conditionalities attached to IMF loan imply a substantial loss of freedom for the country with regard to its socio-economic policy formulation deserves to be examined carefully. During the last couple of years, detailed country-wise studies have been made by the IMF itself to evaluate the experience of applying standard stabilisation packages to a wide range of less developed countries. These studies have revealed many shortcomings of the basic IMF approach of imposing uniform set of conditionalities. As a result, it is now increasingly recognized that in designing structural adjustment programmes, theory has to be blended with specific political, cultural and socio-economic circumstances prevailing in individual countries. In this connection, recent developments in IMF policies, particularly those concerning social safety nets, deserve specific mention. Similarly, the extent of flexibility that the IMF has shown in recent times while dealing with complex issues relating to exchange rate management also clearly suggests that the IMF is perhaps not so rigid now with regard to the application of a standard stabilisation package as it used to be in the past. As a result, there is much greater scope now for meaningful and effective negotiations as well as mutual understanding on the programme of economic policy reforms between the IMF and the Indian government.

5. Strategy for Macroeconomic Turnaround

In the light of the above discussion, we may now examine the macroeconomic strategy for dealing with India's economic crisis. The main ingredients of a strategy designed to lift the Indian economy out of the present crisis and achieve an effective macroeconomic turnaround could be as follows:

1. Profitability of our exports should be systematically improved, so that selling in the domestic market does not necessarily remain more profitable than selling in the international market, as is the case today in many domestic industries. This would require, among other things, improved access to critical imported raw materials and streamlining of various export incentives. The past experience shows that relatively faster growth of exports has been experienced by those industries which had ready access to imported inputs at international prices.

2. Export incentives should be linked to a much greater extent with net exports rather than gross exports, i.e., exports

less import content of exports. This would ensure relatively faster growth of value added exports and also simultaneously encourage internationally competitive import substitution.

3. There is a need to pursue more vigorously the policy of depreciation of the real effective exchange rate. It is interesting to note here that during the period April-December 1990, the real effective exchange rate of Rupee has gone up by about 5.5% (Table 4) and this period is also marked by a sudden sluggishness in India's exports. As against this, the earlier period (1986-89) was marked by a significant decline in real effective exchange rate coupled with significant increase in exports (measured in terms of US dollars). Effective depreciation of Indian Rupee in real terms would lead to a significant improvement in the competitiveness of India's exports and at the same time also improve the viability of several import substitution projects which, in turn could result in a reduction in import intensity in Indian manufacturing.

4. There is a need to focus urgently on the turnaround of loss making public enterprises and simultaneously facilitate the growth of financially viable public enterprises through export oriented modernisation and expansion programmes. Moreover, it is necessary that more and more public enterprises are asked to finance bulk of their current

import requirements through direct export earnings. In 1989-90, the total import of raw-materials and components by central public enterprises was Rs.12,977 crores, whereas their aggregate export earnings were only half of that amount (Rs.6,366 crores). This measure would simultaneously ease the pressure on BOP and contribute to a reduction in fiscal deficit.

5. There is a need to decrease the ratio of government expenditure to GDP by ensuring that the percentage change in government consumption expenditure is significantly less than the expected percentage change in GDP (measured at current prices). Curbing excessive growth of government consumption expenditure is perhaps a more effective remedy to overcome the present crisis than curbing import of raw-materials by potentially export oriented industries.

6. There is a need to accord top priority to improving the performance of basic infrastructure sectors such as railways, coal, power and steel. While these sectors have performed reasonably well during the latter half of eighties, their performance has deteriorated significantly since 1989. The downturn in industrial growth experienced in 1990-91 is partly due to the inadequate performance of infrastructure sectors.

7. While additional dose of taxation in the short run appears to be unavoidable, significant emphasis also needs to be placed on stepping up and streamlining tax collection effort

in the areas of both direct as well as indirect taxes. This aspect assumes special significance in the context of reported shortfall of more than Rs.1,000 crores in the collection during 1990-91. It is evident, therefore, that better tax administration can contribute significantly in achieving the required reduction in budget deficit.

6. Conclusion

In addition to the above mentioned long-term policy measures to restore the economy on the path of rapid and healthy economic growth, it is equally necessary to resolve the immediate problem of liquidity crunch arising out of the accumulated liability of mounting short-term debt that has to be repaid in the near future. Given the present situation in which the opportunities for short-term commercial borrowings have dried up and FCNR accounts have also failed to bring any significant net inflow, what is urgently required is a sizeable medium term bridge loan of around 4 to 5 billion US Dollars to avoid the possibility of any serious repayment crisis cropping up in the next couple of years. Since short-term reliefs that can be provided by the funds available from donor countries like U.S.A., Japan, U.K., France and Germany or international agencies like World Bank and Asian Development Bank are not likely to add up to the required amount, such ad hoc reliefs can basically serve the purpose of providing some cushion to tide over the financial problems for a few months. However, such cushion would not last long enough to enable the country to design and implement a package of major policy changes that could lead to a successful macroeconomic turnaround over the next few years. Hence, tapping such sources for getting small additional funding cannot be considered as an effective alternative to obtaining a large medium term loan as early as possible.

Similarly, the recent measures such as higher bank margins on LCs, revision of interest rates for export credit, modifications in the clearance procedure for large transactions by Forex dealers and modifications in the scheme for issuing REP licences, also belong to the category of ad hoc fire fighting measures aimed primarily at easing the immediate liquidity problem. It is evident that such measures cannot be expected to provide lasting solutions to the current economic crisis. In fact, some of these measures, if continued over a longer period, may adversely affect our export performance in the coming years. In view of this, in the present circumstances, there is apparently no effective alternative to approaching IMF for a large medium term loan to resolve the problem of liquidity crunch over a period long enough to allow the economy to achieve a successful turnaround. At this juncture, IMF loan appears to be more like a necessary condition to overcome the present economic crisis. Whether it would also turn out to be a sufficient condition or not depends essentially upon the manner in which we reformulate our economic strategy and the degree of success that we achieve in its speedy implementation during the next few years.

Table 1

Trends in India's Foreign Exchange Reserves

(Rs. Crores)

Month & Year	Foreign Exchange Reserves	No. of Weeks of Imports Covered by Forex Reserves	No. of Months of Trade Deficit Covered by Forex Reserves
March, 1980	5,934	34	26
March, 1981	5,544	23	11
March, 1982	4,024	15	8
March, 1983	4,782	17	10
March, 1984	5,972	20	12
March, 1985	7,243	22	16
March, 1986	7,820	21	11
March, 1987	8,151	21	13
March, 1988	7,687	19	14
March, 1989	7,040	13	11
March, 1990	5,331	8	8
January, 1991	1,877	2	2
May, 1991	2,620	3	3

Source : (1) Economic Survey 1989-90, Ministry of Finance, Government of India.

(2) Information provided by Finance Ministry in May 1991.

Table 2

Trends in India's Trade Deficit

(Rupees Crores)

Year	Exports	Imports	Trade Deficit	Monthly Average Deficit
1980-81	6,711 (4.6%)	12,549 (37.3%)	5,838 (114.2%)	487
1981-82	7,806 (16.3%)	13,608 (8.4%)	5,802 (-0.6%)	484
1982-83	8,803 (12.8%)	14,293 (5.0%)	5,490 (-5.4%)	458
1983-84	9,771 (11.0%)	15,831 (10.8%)	6,060 (10.4%)	505
1984-85	11,744 (20.2%)	17.134 (8.2%)	5,390 (-11.1%)	449
1985-86	10,895 (-7.2%)	19,658 (14.7%)	8,763 (62.6%)	730
1986-87	12,452 (14.3%)	20.096 (2.2%)	7,644 (-12.8%)	637
1987-88	15,741 (26.4%)	22,399 (11.5%)	6,658 (-12.9%)	555
1988-89	20,295 (28.9%)	28,194 (25.9%)	7,899 (18.6%)	658
1989-90	27,681 (36.4%)	35,412 (25.6%)	7,731 (-2.1%)	644
1990-91	32,527 (17.5%)	43,171 (21.9%)	10,644 (37.7%)	887

(Figures in the parentheses indicate percentage changes over the previous year.)

Source : (1) Economic Survey 1989-90, Ministry of Finance, Government of India, March 1990.

(2) Provisional Estimates of India's Foreign Trade released by Ministry of Commerce, Government of India, May 1991.

Table 3

Trends in Deficit Financing

(Rupees Crores)

Year	Revenue Deficit	Budget Deficit	Fiscal Deficit
1987-88	9,137	5,815	27,881
1988-89	10,515	5,642	30,920
1989-90	11,912	10,592	35,630
1990-91 (RE)	17,585	10,772	43,331
1991-92 (BE)	17,766	9,977	38,475

Source : Interim Budget for 1991-92, March 18, 1991.

Table 4

Trends in the Exchange Rate of Indian Rupee

(Base 1980 = 100)

Year & Month	Index of Nominal Effective Exchange Rate	Index of Effective Relative Price	Index of Real Effective Exchange Rate
1981	96.10	105.08	100.98
1982	94.85	103.86	98.51
1983	87.24	110.76	96.63
1984	84.60	117.31	99.24
1985	78.15	122.87	96.02
1986	64.84	133.73	86.71
1987	57.27	141.61	81.10
1988	50.65	149.67	75.81
1989	45.62	154.02	70.26
1990	43.19	160.49	69.32
April 1990	42.73	158.18	67.59
December 1990	43.15	163.35	71.35

Source : *The Economic Times*, May 17, 1991.

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