MACROECONOMIC REFORMS AND INDIA'S EXPOSURE TO THE 1997-1998 EAST ASIAN FINANCIAL CRISIS

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ABSTRACT

Despite, or perhaps because of, the volume of evidence on the issue, contemporary policymakers and economists are sometimes divided as to the causes of India's 1991 balance of payments crisis, and the role the resulting reforms may have played in India's economic performance during the East Asian Financial Crisis. The focus of the paper is first to determine the sequence of events that led to the balance of payments crisis that prompted Prime Minister Narasimha Rao and Finance Minister Singh to take action. This crisis will be compared with previous macroeconomic crises in India's history to show how the 1991 economic disaster arose purely from poor policymaking. The paper will examine the sweeping reforms enacted after 1991 and will finally show how the gradualist approach to these reforms limited India's exposure to the Asian Financial Crisis of 1997-1998.

CHAPTER 1
INTRODUCTION

In the annals of India's economic history, the year 1991 holds a place of particular honor and marks a profound shift in the ideologies driving India's economic policies. For roughly forty years since its independence, India had embraced an insular economic policy of import substitution, whereby successive governments agreed that India could best achieve economic growth through self-reliance. At the same time the Centre – India's national government – established enormous bureaucracies and monopolies in virtually every market sector. Economic growth stagnated throughout the 1960s and 1970s while the national and state governments simultaneously incurred vast fiscal deficits.

India's unsustainable practices abruptly hit reality in 1991 when the national government faced a dire macroeconomic situation. It found its reserves of foreign currency depleted and came close to defaulting on debt. In response to the crisis, India's policymakers embarked on a series of reforms to make India's economy more competitive and resilient. While many other causes can be explored, the balance of payments crisis can be almost entirely attributed to more than forty years of financial mismanagement. This particular crisis sharply differed from other macroeconomic crises, primarily earlier ones India faced, in that bad policy was the root cause, political outcries to the contrary. The subsequent reforms were the most expansive ever undertaken in India's history. While many analysts agree the reforms in general, by opening the Indian economy to the rest of the world, should have increased India's exposure to the Asian Financial Crisis of 1997, it can be seen that the gradualist approach used by successive governments ensured that India's economy remained mostly untouched by this later crisis. There

is no clear answer on how the aftermath of the balance of payments crisis, whether it is increased government focus on reform or reluctance to dismantle barriers to fluid labor markets, will impact Indian economic growth in the long run. Regardless, understanding the effects of the policies enacted before, during, and after the balance of payments crisis will be crucial to future policymakers.

CHAPTER 2
POOR POLICYMAKING AND THE BALANCE OF PAYMENTS CRISIS

In the immediate aftermath of the 1991 crisis, several journalists and Members of Parliament alike denounced the role of foreigners in the event. Some believed that India almost had to default on its debt because international organizations and unscrupulous currency speculators deliberately undervalued the rupee, thus making it more difficult for the Reserve Bank of India to purchase necessary foreign reserves on currency markets. However, responsible leaders in India's government (and virtually every economist outside India) understood that foreigners played a very minor role in this crisis. India's 1991 encounter with financial disaster actually resulted from the confluence of several factors, including rising import commodity prices and bloated public fiscal deficits, all of which reflected atrocious financial mismanagement for almost half a century. Even a cursory look at the events that led up to the crisis demonstrates that poor policymaking led the economy in the wrong direction.

In the early 20th century, Jawaharlal Nehru and his supporters viewed capitalism as anathema, intrinsically tied to brutal colonialism, and they instead turned to Fabian socialism. A compact created by leaders of the Indian Congress Party in the 1940s argued that the Centre should strictly control economic growth through planning and regulation. Foreign trade would be kept minimal while the government would exercise strict control over the economy.

The Congress agreement was the genesis of the License Raj system, which established a deep-rooted bureaucracy to regulate private sector industries. Before undertaking any venture, whether to develop a new product or seek capital from abroad, a private business would first have to seek permission from the government, which would render a decision based upon plans

for economic growth. Shashi Tharoor claims the system inhibited capital mobility in India and prevented the private sector from behaving as necessitated by commercial concerns. That the government served as an impediment to efficient market function is best driven home by an unnamed worker in Calcutta who commented: "[My father's] job is to figure out ways by which his company can invest its profits at home without falling afoul of the various rules and regulations of the government preventing private-sector companies from expanding," (Tharoor 1997, p. 163). Bradford DeLong believes firms often abused the licensing system and protected their interests by obtaining a license before competitors and watching as subsequent applications were rejected because the government feared overinvestment in any industry (2001, p. 16).

India's economic policies after independence spawned an enormous public sector that, according to John Williamson and Roberto Zagha, accounted for 12.7% of GDP in 1970 and grew at a rate of 9.6% in the same year (2002, p. 34). As the Centre maintained a monopoly in virtually every industry, it had to pay for these firms and incurred massive fiscal deficits along the way. Before taking on debt the Indian government relied heavily on taxation, at one point imposing a 100% marginal tax rate on some citizens. But as the incentives to evade taxes or reduce labor and savings to avoid taxes grew, the Centre and state governments incurred ever-increasing debt burdens. Data from the Reserve Bank of India *Handbook of Statistics on the Indian Economy* show that the gross fiscal deficit rose as a percentage of GDP from 3.08% in fiscal year 1970-1971 to a peak of 8.47% in fiscal year 1986-1987. Furthermore, the total debt of the Centre and state governments, as a percentage of GDP, rose from 48.38 in fiscal year 1980-1981 to 64.86 in fiscal year 1990-1991 (2006, pp. 579-584).

The reasons for the fiscal deficits are many and include massive electricity subsidies for farmers, increasing cash grants from the Centre to state governments, and lack of accountability

in public investments. As part of the effort to maintain complete control over economic development, the Centre and other state governments created electricity and water boards, enormous public utilities which not only regulated the industry but in fact also owned the vast majority of all investment in these two key sectors. As the private sector was deemed incapable of producing sufficient electricity to ensure sustained growth, the mammoth task fell to the public sector. But four decades of government giveaways in the form of electricity subsidies to farmers (which still continue today) drained the government accounts and nearly bankrupted several states, particularly Andhra Pradesh. Electricity boards often neglected to use accurate methods to estimate electricity demand; they further implemented cross-subsidization schemes whereby electricity users in certain sectors paid exorbitant tariffs to subsidize the agricultural sector. The result, as Pradip Chattopadhyay claims, was that large amounts of electricity were stolen in urban areas and sold by black-market profiteers at lower prices (2004, pp. 673-674). Water utilities fared no better under government control; large state investments in water purification plants or other infrastructure undertaken under one government would be immediately abandoned for political reasons. Despite all this, the Centre continued to disburse billions of rupees to the various state governments.

The Nehruvian emphasis on self-reliance inculcated a belief among India's politicians that foreign investment in India's industries would be an embarrassment and so capital flow would have to remain domestic. Under Nehru's vision of the planned economy, domestic production would replace imports wherever possible, and instead of exporting goods, they would be consumed within India. "Headless India" states that as a result, India's share of world exports declined by 80% between 1950 and 1990 while its share of poor-country exports declined by 75% over the same period (1991, pp. 20-21). Simultaneously, exorbitant tariffs discouraged

import trade – at one point in 1991 the Centre implemented a tariff of 300% on certain imports. In the late 1980s, the Centre began to relax trade restrictions with the hope of increasing exports. By 1985 Prime Minister Rajiv Gandhi grew impatient with the sclerotic, bureaucratic License Raj and implemented a series of small reforms. As part of his efforts he scaled down import quotas and created new categories for goods that could be exempted from certain tariffs. Tharoor holds that unfortunately, this action merely increased the government's discretionary authority and largely left the problems of the economy untouched (1997, pp. 170-171). Prior to the balance of payments crisis India's largest trading partner was the Soviet Union, from which it received military equipment and to which it sent raw inputs and commodities. Upon the Soviet Union's collapse, India had to reassess its economic relations with the remaining Commonwealth nations and found itself without a strong trading partner. According to Ramesh Thakur, industries in the new nations fulfilled Indian contracts haphazardly while India, instead of exchanging goods for payment or other goods, credited Russia for billions of rupees. By 1991, India had lost its primary, and for some industries the only major, trading partner. Finally, Thakur claims that the years 1990-1991 saw a worldwide recession in which India's exports to all its trading partners grew at a much slower rate than in the previous half-decade. Worldwide growth declined from 4.5% in 1988 to 2.25% in 1991 (1992, pp. 175-179). The dramatic slowdown in export growth meant that payments to India were not enough to service the debt.

In conjunction with the limitations on exportation of raw and finished goods and on importation of capital goods, the Centre forbade foreign investment in domestic Indian industries. This was, after the License Raj quotas and limits on private sector expansion, one of the most inhibitive hurdles to private firms that sought growth. Though the Organization for Economic Cooperation and Development believes the benefits of inward FDI are well

documented and include development of human capital, improvement of technology in developing nations, and establishment of superior corporate governance, Indian politicians tended to emphasize the negative effects (2002, p. 6). Extremely mistrustful of foreign corporations, most Members of Parliament saw foreign capital and foreign companies as ruinous to Indian laborers by encouraging unsound environmental practices, depriving farmers of their livelihoods, and forcing profits to be repatriated abroad.

Immediately after independence, and for two subsequent decades, India retained a moderately sized stock – roughly 2.5 billion rupees worth – of foreign investment, mostly left behind when the British relinquished control over India. The majority of this investment was focused in the extractive industries, with tea plantations lagging slightly behind. As the Centre launched massive industrialization and protection of domestic industries in the 1950s, foreign investment grew at a steady rate toward industries that received favorable government status. Nagesh Kumar states that though Nehru professed the importance of a centrally planned economy, he also claimed to support foreign investment in India. Inward FDI grew steadily, from 2.5 billion rupees to 5.65 billion rupees, until 1968 when the government sharply reversed its direction on foreign investment. Between 1947 and 1968, outward FDI, or investment from India in ventures abroad, was almost nonexistent as there was little free capital to send overseas. In 1968, under the leadership of Indira Gandhi, the Centre adopted a far more restrictive stance towards FDI. The Foreign Investment Board (FIB) limited foreign equity ownership to no more than 40%; all foreign investment had to be accompanied by technology transfer, without which the application would be summarily rejected (1995, pp. 3-10). Though individual investors and firms now had the capacity to invest abroad, their options were severely limited by Parliament. In the 1980s, Rajiv Gandhi would attempt to revisit the subject of FDI, but reforms in this area

would have to wait until 1991. In a country as poor as India, where domestic capital was scarce, this lack of foreign investment led to stagnation of those firms that lacked political favor.

Indian consumption of crude oil grew sharply after the 1960s as the government promoted mass industrialization. However, the country was, and remains, a net importer of oil and natural gas, meaning economic health became highly dependent on the stability of oil prices. Valerie Cerra and Sweta Saxena find that subsequent to the invasion of Kuwait, rising oil prices and increasing demand for oil pushed the Indian value of petroleum imports from $2 billion to $5.7 billion between 1990 and 1991 (2002, pp. 400-404). By having to spend an increasing fraction of national wealth on petroleum, the Indian government had less money to honor debt obligations.

None of these factors (four decades of the painfully socialist License Raj, the extortionate tariffs, the collapse of the Soviet Union, and the aggregate supply shocks) individually were influential enough to convince Members of Parliament to abandon the socialist doctrines. The convergence, however, nearly collapsed the fragile Indian economy. In 1991, the Congress-led government selected as Prime Minister P.V. Narasimha Rao, who then chose Manmohan Singh, a former Governor of the Reserve Bank of India, to be his Finance Minister. The immediate hope of the government was to prevent the country from defaulting on its foreign obligations, which would permanently tarnish its economic reputation.

From 1947 to 1991, India's government subjected the economy to strict socialist controls. The enormous public bureaucracy (run by corrupt civil servants), strict wage controls, limits on foreign direct investment, limits on expansion, and high tariffs and quotas inhibited the economy from growing much more than its "Hindu Rate of Growth." Though many in India would have liked to blame its economic woes on foreigners, Tharoor posits that the Rao government took

responsibility for many of the problems and accepted the blame for the mistakes of previous Congress governments. Instead of promoting inward-looking socialism, Rao and Singh vowed to emphasize foreign trade and responsible fiscal policy. In a 1996 speech Singh proclaimed, "Those who oppose foreign consumer goods companies are enemies of Indian consumers. They want people to be content with shoddy goods as for the last forty-five years, and only help smugglers to thrive," (Tharoor 1997, pp. 180-181).

CHAPTER 3
THE BALANCE OF PAYMENTS CRISIS COMPARED WITH OTHER MACROECONOMIC CRISES

There existed, and still exist, some Centre politicians who maintained that the 1991 balance of payments crisis was not caused by internal policy but by exogenous factors. The sudden increase in the price of oil and the collapse of the Soviet Union lent credibility to their claim. The arguments of these politicians often made comparisons to previous macroeconomic crises in India's history or similar crises in other parts of the world. In the previous crises, as with the one in 1991, inflation rose dramatically while the private sector experienced a contraction. As subsequent analysis would show that these crises were caused by factors beyond the control of politicians, a faction of the opposition party and of the Congress Party held that there was no reason to suspect that the cherished socialist dogmas were to blame for the 1991 crisis. But the comparison they made on the basis of symptoms is grossly misleading. A deeper investigation into the underlying causes of each of the crises reveals that previous crises were indeed caused by exogenous factors while the 1991 crisis resulted almost entirely from bad policy.

While Indian politicians debated the appropriate reaction to the 1991 crisis, or whether this crisis merited a shift in policy, economists worldwide were firmly convinced that a new policy direction was necessary. Furthermore, members of the IMF believed that Rao's government would fail to implement the necessary reforms, using as evidence India's reaction to similar macroeconomic crises in its history. Since independence, India had experienced three such macroeconomic disasters: from 1965 to 1967, 1973 to 1975, and from 1979 to 1981. The

reason many economists (before the Rao government implemented reforms) believed the government response would be more of the same was that after each of the three earlier crises, the Centre's embrace of socialism remained as strong as ever. It is easy to notice that the causes of the three earlier crises were beyond political control. In 1965 a worldwide food shortage coupled with two successive Indian droughts sent the price of food skyrocketing in India; the government had to implement a policy of food price stabilization. Through monetary measures, the government restrained inflation but at the price of a steeper recession. The 1973 rise in oil prices again sent the Indian economy into recession, much deeper than the rest of the world because India's economy was relatively closed. Rising food prices contributed to inflation. In 1979, world oil prices again skyrocketed, sending the Indian economy into a tailspin. In the aftermath of each of these earlier crises the Centre took greater control of food distribution and established repositories for grain and fuel in case of future crises.

Joshi and Little argue that from this basic survey of earlier macroeconomic disasters in India's history, it is easy to discern the contrast with the macroeconomic crisis of 1991. It is true that oil supplies were cut and trade with the USSR collapsed, but these supply shocks would probably have had a much smaller effect on economic performance, relative to the previous supply shocks. The reason is the Centre had learned its lesson and built up large reserves as buffers (1994, pp. 73-221). The supply shocks would not have been as damaging to the economy as the sheer reluctance to enter the global economy and maintain cash reserves, acts that would have required India to dismantle its repressive economic controls. Contrasting the 1991 crises with previous Indian crises or other international debt crises may seem unnecessary, but understanding the differences in underlying causes is important because it may give policymakers clues on how to appropriately guide the economy.

Other economists made comparisons between India and Latin American countries which experienced debt crises, holding India to be another poor developing country whose citizens lacked the impetus to sustain economic growth. To an extent, this comparison is not unfair; it is true that at one point India's colossal external debt of $71 billion was exceeded only by those of Brazil and Mexico. However, India's situation differed dramatically from that of other developing debtor nations. India's official estimates of inflation placed it around 14% in 1991, the year of the crisis, while in 1985, around the time Brazil faced its debt crisis, Brazilian annual inflation approached nearly 250%. Furthermore, while the federal government enacted national incomes policies to contain wage growth in Brazil, the strict control the License Raj already held over wages implied that the Reserve Bank of India was primarily responsible for controlling inflation. This means that the Indians had placed a central bank, not a fiscal institution, in charge of monetary policy and had given it far greater powers than similar central banks in Latin America. Furthermore while India continued its plodding growth rate of 3.5%, Argentina, Brazil, and Mexico, in the middle of their crises, expanded at much smaller rates. What these factors demonstrate is that despite the Indian government's interference with the economy, fundamental indicators showed that the Indian economy was in a strong position to recover, given appropriate reforms (see also Krugman 1979).

The 1991 Indian balance of payments crisis was unique for India and for Third World nations overall. Unlike other economic contractions in India's history, this particular disaster resulted from poor decisions on the government's part. Additionally, unlike other developing countries, India's economy was fundamentally strong and only required policy reform to be able to grow.

CHAPTER 4
THE REFORMS OF RAO'S GOVERNMENT

In 1991, Indians voted P.V. Narasimha Rao into office with the hope that he could lead India out of the economic crisis. But Rao accomplished far more than that; the reforms of the Rao government swept many of Congress' socialist dogmas away and were the most expansive ever seen in India's history. A second caveat, the importance of which will be seen later, is that these reforms were implemented gradually so that Rao could hold onto power as long as possible.

As India's foreign currency reserves shrank to almost nothing and default appeared imminent, PM Rao and FM Singh's immediate response was to secure an emergency loan of $2.2 billion from the International Monetary Fund. The Centre put up India's gold reserves as collateral for the loans, an act which jarred the public into accepting economic reforms.

Having secured a mandate, Rao and Singh embarked on a series of reforms that were far more sweeping in scope than Rajiv Gandhi's modest measures in the mid-1980s. Contemporary researchers sometimes credit an attitude shift in the 1980s with a near doubling in growth rates that occurred before 1991, and claim that the increased growth would have continued into the 1990s. DeLong claims that the long-term impacts of Gandhi's modest reforms increased the long-run steady-state growth rate by 54%. The Rao government's reforms had a long-term impact of between one-half and two-thirds of this value (2001, p. 27). Yet this only tells part of the story, for this alleged attitudinal shift was not influential enough to inculcate greater fiscal responsibility among India's policymakers. Dani Rodrik and Arvind Subramanian hold that Rajiv Gandhi's ascension to the Premiership of India marks the beginning of India's

transition from anti-business to pro-business, although not from anti-market to pro-market. As Prime Minister, Gandhi emphasized increasing the profitability of extant corporations or public sector monoliths; liberalizing trade and opening up the economy were secondary concerns (2004, pp. 2-3). During his tenure, Gandhi emphasized cutting marginal corporate taxes, revising India's antitrust policies to allow mergers and expansions, and lowering licensing restrictions on the manufacturing industries. In the final months of his Premiership, Gandhi made a minor attempt to cut price ceilings on industrial materials. Gandhi's economic policies were geared to shoring up India's export industry, but at the same time he firmly maintained most restrictions on product and capital imports. In retrospect, economists such as Montek Singh Ahluwalia claim that although growth rates almost doubled during the Gandhi years, this new pace was unsustainable, having been fueled to an extent by a build-up of international debt, which eventually caused the 1991 crisis (2002, p. 65). DeLong also posits that in the absence of the post-Crisis reforms, Rajiv Gandhi's attempts at liberalization would later have little to no effect on economic growth (2001, p. 6).

It is easy to see, upon close inspection, how much more Rao's government opened up the economy and the positive effect these reforms had on the psyche of India's millions. The sale of India's gold reserves to pay for an emergency loan jarred Indian policymakers into acceptance of the reforms. Virtually every sector of the economy was influenced and slowly liberalized by the new government's actions.

Among the many goals was to reduce the Centre and state fiscal deficits and bring fiduciary responsibility back to the government. At the highest point, the Centre's gross fiscal deficit as a percentage of GDP was roughly 8.47% in fiscal year 1986-1987; this value dropped slightly to 7.85% in fiscal year 1990-1991, but the general trend of high deficits pushed the

country into taking on increasing amounts of debt before the 1991 crisis. Rao forced the Lok Sabha (the lower house of Parliament) to accept more austere budgets for several consecutive fiscal years; data from the RBI Handbook of Statistics show that within one year the deficit dropped to 5.56% of GDP, and by the time the Rao government left office in 1996 the deficit stood at 4.88% of GDP (2006, pp. 579-584).

In the early years of the new administration, Rao and Singh turned their eyes to monetary policy. When Rao's government stepped into office in 1991, Indian inflation was worrisome. After hovering around 7% for most of the 1980s, inflation leapt to 10.3% in fiscal year 1990-1991. There were many causes for this abrupt increase in prices; among them was rapid growth of monetary aggregates during the 1980s. To pay for new social and economic programs, Rajiv Gandhi's government leaned on the Reserve Bank of India to print more money. Joshi and Little state that M1 increased by 11.4%, 17.3%, 14.5%, 15.1%, and 19.9% respectively for the fiscal years 1985-1986 to 1989-1990. Meanwhile, M3 increased by 17.1%, 17.6%, 17.0%, 17.4%, and 19.6% in the same fiscal years. The lagged effect of the 1989-1990 expansion appeared in 1990 and 1991 (1994, pp. 189-196). Additionally, oil shocks from the Persian Gulf, combined with higher food prices, played a significant role in the high inflation, but it was clear to policymakers that unlike previous bouts of high inflation, such as during the previous three macroeconomic crises, this inflation was not caused by exogenous factors. Rao and Singh realized that highly expansionary monetary policymaking, used to bolster economic growth in election years, was the primary cause and instructed the RBI to reverse the previous trend.[1] The RBI *Handbook of Statistics* data show that under orders from the new government, the RBI cut M1 and M3 growth

[1] Note: unlike in the United States or the United Kingdom, India did not have, and today still lacks, what is considered an independent central bank. While all central banks face political pressure in some form, perhaps through appointments or inflation targets, India's central bank remains under the direct control of the elected government.

rates to 14.6% and 15.1% respectively. Unfortunately, poor governance at the RBI would lead to higher monetary aggregate growth rates between 1992 and 1996. However, the crux of the abrupt 1991 decrease in M1 and M3 growth rates was a noticeable drop in inflation to 8.4% by 1993 (2006, pp. 573, 577).

Since the balance of payments crisis arose because India lacked sufficient foreign currency reserves to pay off external debt, Rao and Singh made a focal point of their policy building up Reserve Bank of India cash reserves. India operated a closed and insular economy compared with the West, and so the Indian government believed it only needed foreign reserves to service external debt and make payments for minimal imports. Prime Minister Rao realized that if he were to achieve his goal of significantly expanding international trade beyond the United States and what was left of the USSR, India would have to acquire far greater cash. In US dollar value, the RBI held only $2.2 billion worth of foreign currency reserves in 1991 (this mostly from the emergency IMF loan). This became $5.6 billion in fiscal year 1991-1992, $6.43 billion in 1992-1993 and $15 billion by fiscal year 1993-1994. Since fiscal year 1996-1997, these currency reserves have not dipped below $20 billion (see Appendix 3). Though this particular reform lacked political exposure, it earned the Rao government the respect of international economists who would come to realize that the Prime Minister was serious about economic reform.

The significant acquisition of these currency reserves could not have occurred without a concurrent devaluation of India's currency. The government's first step in currency markets was to allow the full convertibility of the rupee, previously traded at a fixed rate, against other currencies. Currency devaluation was a measure commonly taken by developing countries in the face of trade liberalization and growing trade imbalances; it was also a politically volatile issue

because it was perceived as succumbing to foreign powers. Devaluation of the rupee in the fiscal year 1965-1966 nearly cost the Congress government its majority in Parliament. Ramashray Roy believes that Rao and Singh risked their nascent government's authority by embarking on a plan of phased devaluation. Following the transition to full currency convertibility, the rupee depreciated by 8%; subsequent depreciations brought the total devaluation of the rupee relative to the dollar, during Rao's tenure, to 22% (1994, p. 202). Incidentally, econometric analysis shows that in both the late 1960s and the late 1980s, the rupee was significantly overvalued. Both attempts at devaluing the currency were merited with bringing the actual exchange rate to the general equilibrium exchange rate. In particular, according to Sandwip Das and Manoj Pant, this action was integral to Rao's holistic vision of economic reform; without it, India's trade deficit would have widened and unemployment would have risen slightly (1997, pp. 51-66).

The two sectors where perhaps the most important reforms were undertaken were foreign direct investment (FDI) and international trade. Through these changes, Prime Minister Rao hoped to bring India's economy more in line with global trends. Though some Indians, particularly members of the opposition in the Lok Sabha, saw FDI and increased trade as forerunners of a return to foreign imperialist rule, Rao and Singh conceded that continued reliance on domestic investment would harm prospects for future economic growth.

There was no standard definition for what constituted FDI in 1991, but Rao's government saw a clear need for allowing the movement of foreign capital in India. Sector by sector, the Centre removed limitations on foreign investment in India, but the process was long and arduous. Before opening any industry to foreign investment, the Prime Minister and Finance Minister established committees to study the influence of foreign investment on the national balance of payments. The New Industrial Program (NIP), authorized by Rao and Singh, gradually

liberalized foreign investment in India. The process continued slowly from 1991 to 1996, so that the Prime Minister was not perceived as turning control of the Indian economy to foreign capitalists. Foreign ownership limits were raised to 51% – granting majority stake over many privatized firms – and 100% equity ownership was allowed in the energy sector. The FIB was replaced by the Foreign Investment Promotion Board, which sought to attract foreign capital to India and which removed most of the investment restrictions that plagued Indians who hoped to invest abroad. Kumar states that between 1991 and 1993, total inward FDI amounted to 131 billion rupees (1995, pp. 14-16).

The loosening of restrictions on FDI was one aspect of the reforms the Rao government enacted in international trade. Phillipe Aghion et al. find that before the crisis of 1991, India had among the highest tariffs and most restrictive quotas in the world. Between his assumption of the office of the Premiership and 1992, Prime Minister Rao cut tariffs by an average of 22%; from 1992 until his election loss in 1996, he further reduced tariffs by an average of 29%. In the first period, the highest tariff level dropped by 235%, and for the entire period of his administration, the highest tariff reduction was 270% (2003, p. 39). Quota restrictions were cut by even larger percentages. Not all industries received equal treatment during the trade liberalization process. The most rapid trade liberalization occurred in the manufacturing sector to allow producers to import capital goods; textile imports, however, required far more time as Parliament debated the issue for months.

A highly contentious trade issue in the early 1990s was the question of whether India, a signatory to the General Agreement on Trade and Tariffs, should withdraw from the treaty and the World Trade Organization (WTO). Large firms which had enjoyed the government's protection for many decades lobbied against the GATT while opposition parties, seeking an

exploitable political opportunity, condemned the Congress Party for sacrificing Indian business interests to the international community. The Centre was pressured not to make any concessions in the trade talks, but despite opposition, Rao and Singh eventually negotiated India's entry into the WTO.

The government tried to dismantle the public sector by selling minority stakes to domestic and foreign private companies. Investors expressed deep reluctance to buy minority stakes in public firms that would remain poorly managed by bureaucrats. According to Tharoor, as late as 1992, nearly 104 out of 297 major public sector companies experienced net losses, amounting to 40 billion rupees. In response to these concerns, the Centre sought approval from Parliament to sell controlling stakes in utility and steel firms to foreigners (1997, p. 161).

As seen, Narasimha Rao and Manmohan Singh dramatically transformed the Indian economy with the hope of raising it from developing country status. Their ideologies were rooted in sound economics but their actions were hindered by politics. Understanding the necessities for Rao's gradualist approach may well be important for contemporary and future policymakers.

CHAPTER 5
GRADUALISM AND THE ASIAN FINANCIAL CRISIS

The reforms undertaken during Prime Minister Rao's administration were by far the most dramatic in India's history. The only comparable measures were those implemented by Rajiv Gandhi, but as was posited, the gains in growth seen during the late 1980s would have dissipated by the mid-1990s, had the 1991 crisis never even happened. Although the changes from 1991 onward affected nearly every sector of the Indian economy, it would be a mistake to assume the reforms occurred abruptly and simultaneously. Finance Minister Singh was an economist and a technocrat but Prime Minister Rao was a politician by trade and severely restrained by forces within and outside his own party. Generally appreciative of the reforms, economists and Western political commentators also reproached Rao and Singh's gradualist approach for failing to act more rapidly. The reforms were debated and studied for weeks; Parliament established lengthy timetables for reforms in politically important sectors. Additionally, a few industries received only cursory reform with the intention that more would follow later. However, though the result was by and large unintentional, that India still remained relatively closed to the international community, compared with its south Asian neighbors, ensured that the country's economy remained virtually untouched by the Asian Financial Crisis of 1997.

In a few instances, economic transformations occurred rapidly but for the most part, Rao commissioned different committees to study and report on each aspect of his proposed reforms. As state elections were no longer tied to national Parliamentary elections, Rao believed that every state election would become a referendum on his reforms. To downplay the importance of his economic plans, Rao avoided privatizing certain sectors with powerful lobbies, firing public

workers, or closing unproductive factories. Rao further refrained from censuring state governments for profligate spending; he thus hoped that the public at large would receive the benefits of his reforms without noticing too big a difference in the status quo.

The unfortunate effect of this gradual approach was that by 1996, when a new party was voted into power, certain industries, such as communications, failed to see much needed reform, there was no guidance to state governments on how to privatize infrastructure, and few if any measures were taken to bring efficiency to the legal system.

Many of the reforms which Rao and Singh delayed and hoped to implement after being reelected in 1996 were abandoned with the change of government. Even with the return of the Congress Party to power in 2004, particular reforms remain to be addressed. These included lowering agricultural tariffs and subsidies as well as removing the Reserve Bank of India from the direct control of the government. However, making a case for future reforms is beyond the scope of this paper.

The loudest concerns regarding India's gradualist approach from 1991 to 1996 arose from those who argued that a form of "shock therapy" would be more appropriate for stimulating growth. Announcing reforms but stretching the implementation over many years would dramatically reduce the net present value of the gains. Though Singh expressed earnest desire to undertake reforms as quickly as possible, political realities inhibited him from doing so. Economists inside and outside India clamored for faster movement; the government accommodated these requests to an extent by asking committees, particularly those studying change to the financial sector, to conduct their reports more quickly. The Tarapore Committee on capital account convertibility, the Khan Committee on harmonizing banks, and the Gupta Committee on rural credit each responded by producing reports in the years 1997-1998, ahead of

schedule but after the Rao government was voted out of office. The efforts to invigorate government reforms came to a grinding halt with the Asian Financial Crisis of 1997.

James Gerber states that the crisis began in Southeast Asia; several nations in the region had long pegged their currencies to the dollar, and when the dollar appreciated in the early 1990s, so did these Asian currencies. The rapid appreciation resulted in serious currency misalignments that made exports from the affected nations much more expensive. China and Japan compounded this problem by devaluing their respective currencies. Export revenues in Thailand and its neighbors dropped precipitously in a few short months during the mid-1990s (2005, pp. 283-284).

For most of the 1990s, high interest rates in Southeast Asia attracted investors from America and Europe. Most of the money was used to purchase securities or to speculate in currencies. But in 1997, as investors lost confidence in East Asia, partly because of declining export revenues, they began selling the securities and withdrawing their funds on a massive scale. The primary result of the capital flight was that several East and Southeast Asian nations, particularly Malaysia, Thailand, and Indonesia, saw catastrophic drops in the value of their currencies and equity markets. As the domestic currencies plummeted in value, many of these countries could not purchase sufficient foreign reserves on currency markets to pay for imports. At that point, other East Asian nations, except Japan, experienced economic distress as international trade fell in the region. The International Monetary Fund earned substantial resentment from politicians in Southeast Asia when it provided emergency loans conditioned on substantial fiscal reform. Curiously, despite its proximity to, and its trade with, other Asian nations, India was mostly unaffected by the turn of events. We finally turn our attention to

understanding how the gradualist approach to the reforms undertaken after the balance of payments crisis insulated India's economy.

India was far less susceptible to the Asian Financial Crisis than its neighbors. Primarily, India devalued the rupee multiple times during Rao's tenure so that by the time Rao was voted from office, the rupee had depreciated 22% relative to the dollar. By shifting to a floating currency before any of its neighbors, India avoided the currency misalignments that proved so catastrophic during the Financial Crisis. The figure below illustrates how the number of rupees per dollar slowly increased between 1992 and 1996, the period of Rao's government. Other Asian currencies saw major currency depreciation during and after the Asian Financial Crisis.

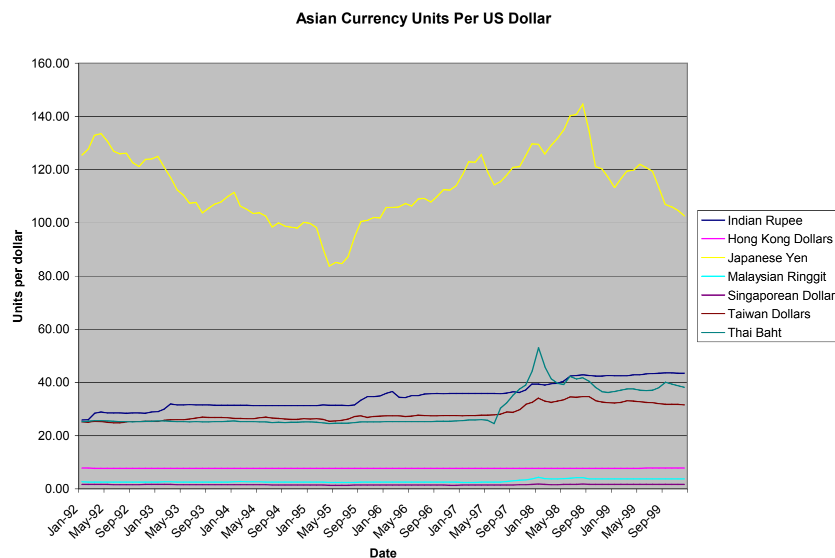

Figure 1 - Currency movements in relation to the dollar. Source: St. Louis Federal Reserve Bank FRED

Next, capital importation restrictions on foreign direct investment were eased well before foreign individuals or firms were allowed to own portfolio investments such as government-issued or firm-issued securities. Similar to China, one of the East Asian nations least affected by the 1997 crisis, India enjoyed a large portion of foreign investment in the form of physical capital. This means that before investing in equities, foreign firms established factories and sold

equipment in India. Thus, capital flight was far more difficult than in India's neighbors. Williamson and Zagha believe that had the Tarapore Committee completed its study sooner, and had the Centre implemented the committee's radical demand for full capital convertibility (concerning outflows as well as inflows), it is likely that India would have suffered increased capital flight (2002, p. 26).

Third, as the International Monetary Fund commented several years later, India's laudable performance was in part due to the stalling of trade reform. International trade accounted for only 8% of GDP in 1997 (and stayed at that level even as late as 1999) while trade with Southeast Asian nations comprised only 13% of all international trade. India still directed much of its trade to former Soviet nations and the United States; though some economists posited that trading so much with a select group of nations exposed India to more idiosyncratic risk, events in 1997 demonstrated the soundness of the Centre's judgment in this situation. The figure below illustrates how Southeast Asian nations that traded heavily within the region experienced a sudden drop in export revenues just before and during 1997; India's export revenues were stable because the country engaged in comparatively low trade within the region.

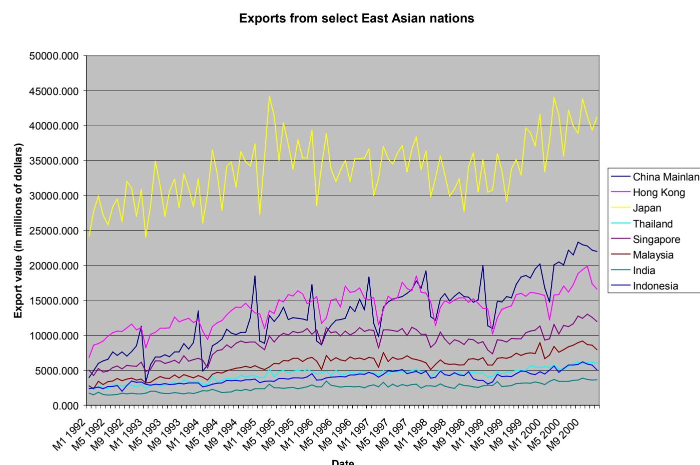

Figure 2 - Exports from select East Asian countries before and after the Financial Crisis. Source: IMF International Finance Statistics Service

Additionally, theories of international trade state that countries which devalue their currencies to improve their balances of trade often suffer through what is illustrated by the J-curve. That is, the balance of trade deteriorates before it improves. Murli Buluswar, Henry Thompson, and Kamal Upadhyaya find no such evidence that India suffered, or will suffer, a deterioration in its long-run trade balance because of its devaluations (1996, pp. 429-432). This may be because India devalued its currency slowly over a period of four years, giving Indians ample time to adjust to rising import prices and to find new markets for exports. However, India's Southeast Asian neighbors, afflicted by the Asian Financial Crisis, had to devalue their currencies without delay, and the shock of the devaluation led to high volatility in exports.

Additionally, private capital inflows accounted for a far smaller percentage of GDP in India than in India's neighbors. While it is true that the Centre removed restrictions on maximum allowed equity ownership, it did this slowly. During the process of removal, foreign investors had to develop trust that the Indian government would honor the investors' equity stakes; in contrast, similar restrictions had been eased in Southeast Asia for several decades. China, for example, began dismantling capital inflow restrictions soon after the death of Chairman Mao Zedong in the late 1970s. According to "IMF," between 1992 and 1996, net inflows of private capital only accounted for 1.5% of India's GDP, but came to roughly 8% of Thailand's and 10.5% of Malaysia's GDPs.

The previous measures reflect a general Indian economic position of reluctance to depend on foreign capital. Rao and Singh advocated opening the Indian economy to global market forces, but remnants of the pro-socialist camp of Congress still expressed reservations on opening capital markets too quickly. In part, a nationalistic sentiment may have further dissuaded Indian firms from relying too heavily on foreign investors. More than any of its

neighbors, India depended largely on the remittances of its expatriate citizens. While the loss of these remittances contributed to the balance of payments crisis, purchase of debt securities by Non-Resident Indians in 1997-1998 alone accounted for over $4 billion of public and private investment (1999, p. 1-2). It is possible that without these forces at work, India may have suffered serious losses in the 1997 crisis, which could have compelled policymakers to rescind reforms.

CHAPTER 6
CONCLUSIONS AND IMPLICATIONS FOR THE FUTURE

Analysis of gradualism's role in the East Asian Financial Crisis produces mixed results. It is almost certain that the slow implementation of public and private sector reforms coupled with the lack of full current account convertibility prevented the crises from affecting India. Yet the reluctance to depend on foreign capital and the deceleration of reforms may have hurt future growth. Regardless, we must try to apply the lessons from India's economic history to contemporary trends.

That India's balance of payments crisis was caused by poor policy, and differed in this respect from previous Indian macroeconomic crises, may appear to have little bearing on how the reforms of the Rao government were so sweeping or why the gradualist approach inadvertently benefited the Indian economy from the East Asian Financial Crisis. Indeed, the conclusions of each of the previous topics may seem incompatible with each other. However, by studying these events, policymakers can create a guideline on how they should approach economic decision-making. This lesson is that policymakers must maintain a stable economic environment that encourages, not hinders, the private sector as it seeks growth and expansion; at the same time, policymakers must temper free market reforms by helping workers adjust to the new economic environment.

For nearly four decades, Indian policymakers violated this rule on several levels; the government stood as a giant monolith blocking the path to economic growth. Government agencies wasted resources while inexplicable restrictions prevented the private sector from acting according to commercial interests. As a result, India's economy stagnated. In the 1990s,

Rao and Singh chiseled away at inhibitive restrictions, paving the way for higher rates of growth. The mediocre 3.5% average rate of growth between the 1940s and 1980s, dubbed the Hindu Rate of Growth, made way for rates of growth exceeding 7% and 8%. The reforms of the Rao government appear to be in accord with the prescription above. However, the gradualist approach to the reforms seemingly contradicts the principle; policymakers slowly removed restrictions on economic growth, but the unintentional consequence of this may have been that India's economy was saved from the 1997 crisis. Upon closer inspection one could see that the slow increase in international trade and the reluctance to depend on foreign investment may have hurt long-term growth prospects. The ultimate effects of government policy are uncertain.

Indian policymakers would do well to apply lessons from the events of the previous generations. Successive governments have continued implementing changes, but many sectors are still sorely lacking reforms. Despite Prime Minister Rao's efforts to bring down fiscal deficits, they continue to number almost 10% of GDP. Inflation currently runs at 6% while Indian public debt is almost 80% of GDP. "India on Fire" claims these variables, combined with a stock market in which asset prices have increased by a factor of four in as many years, lead many to think that India's economy may be growing too quickly and that the government could experience another economic crisis in the next few years (2007, pp. 69-71).

Policymakers will undoubtedly remember how poor policymaking, not exogenous factors, caused the balance of payments crisis in 1991, and how the reforms of the 1990s, more expansive than any before, pushed India's growth rates to unprecedented levels. Though economists often lament the slow implementation of reform in developing countries, in this case gradualism may have been to the benefit of India's economy in the short run. It remains to be seen whether similar gradualism will be detrimental in the long run.

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