2.1 State of the Indian Economy - Observations and Assessment

The Indian economy has accomplished almost four decades of planning and this has been a period in which the economy has achieved varying degrees of success and failure and this has also been an era of experiment which has taught some hard lessons to the policy makers. It is no denying the fact that in the course of the last four decades there has been a constant need to arrange and rearrange priorities between development objectives to adjust to circumstances as they evolved. Some of these circumstances reflected policy failure while others were a reflection of micro-economic inefficiencies and structural imbalances prevailing in the economy. The issue is whether the Indian economy has shown the much needed resilience in combating both the exogenous and endogenous economic crises as they evolved; whether the macro-economic performance has been sustained to the extent it was desired in view of constantly changing economic environment and also changing priorities between development objectives. The answer to such a question is neither positive nor negative since it is a mixture of successful performance in some areas and rather disappointing experience in some other crucial areas. Nevertheless some of the more obvious achievements and equally more obvious failure could be noted without striking a balance between them.

Both performance and policy are in some sense best judged in terms of the objectives of development policy, the more so in an economy like Indian in which objectives have been consciously set and assiduously pursued in successive national plans. The broad objectives which have guided India's development strategy are following :

a) Achievement of a high rate of economic growth leading to a sustained improvement in the levels of living of the population. This high growth is to be accompanied by price stability.

b) reduction in inequalities, and more especially an accelerated effort to remove poverty at a pace faster than would be achieved solely through the normal growth process.

c) Development of a mixed economy with a strong public sector, especially in key areas of the economy. This is in order to achieve broader objectives of growth with equity and also to enable the state to have a sustantial direct control over important production sectors.

d) Achievement of a high order of 'self reliance' has been an important independent objective which is to be viewed in two important ways : In one sense, self reliance means that development must be financed as far as possible from domestic savings, avoiding excessive dependence upon external assistance. On the other hand, it also means a conscious effort at developing a broad domestic production base and an indigenous technological capacity, both of which are felt to be essential requirements for building a strong industrialized economy.

e) Promotion of balanced regional development, with a narrowing of economic difference across regions.

These broad objectives have been evident from the very early stages of planning in India. Overtime they have taken more concrete shape as distinct objectives. It is obvious that an appropriate assessment of performance of Indian economy could be made only in terms of these objectives as well as in identifying some key aspects of policy and future priorities.

Growth Performance :

The rate of growth of the economy is the most commonly used measure of overall performance and is utilised here. Upto about mid-seventies, India's trend growth rate of GDP, ignoring yearly fluctuations, seemed firmly anchored at about 3.5 percent per year, the socalled 'Hindu rate of growth'. The economy broke through this constraint sometime in the mid-seventies; the growth rate over the past fifteen years or so averages about 4.5% and this is an average over a period in which growth has been accelerating. The underlying growth rate of the economy in the mid-eighties is nearer 5 percent per year (Table-I). It seems Indian economy has certainly emerged from the pattern of sluggish growth evident upto the mid-seventies, to a much better performance subsequently, especially in the most recent years. A growth rate of 5 percent is now definitely sustainable and could even be bettered in future if the considerable unutilized potential built up from past investment in the economy is effectively exploited.

Agriculture

A key element in the improvement in aggregate performance was improved performance in agriculture. This not only contributed to faster growth of GDP but also stimulated industrial growth through well known linkages between the two sectors. The compound growth rate of production from all crops has increaaed from about 2.5 percent in the period 1950-51 to 1967-68, to about 3 percent after the mid-seventies. The compound annual growth rate of the index of agricultural production in the more recent period, from 1980-81 to 1988-89 is about 3.4 percent (Table 2). Expansion of irrigation had made agricultural growth less vulnerable to the vagaries of monsoon. Dependence on large scale imports of food grains has been almost eliminated and in number of years, grain reserves do build up. Agricultural development has also directly helped in alleviating poverty since two thirds of the poor derive their income from this sector. Data from recent years suggest that the rate of growth achieved in Agriculture is still short of the 4 percent target growth of agricultural production in Seventh Five-Year Plan (1985-90) but there are good reasons to believe that an acceleration to 4 percent growth is possible because of the structural and institutional changes which have taken place in the agricultural sector over the past years. Though the institutional system needed to deliver the necessary inputs has a much wider coverage today than it did a decade ago, its full potential for increasing yields has yet not been realized. It is true that there has been an impressive increase in irrigation potential with the addition of about two million hectares of irrigation capaity every year. However, effective utilization of this capacity has lagged behind because of insufficient investment in the construction of field channels and drains and also because of inefficient water management practices. Despite the increase in the area covered under high-yielding varieties in the recent years, yields have not increased as much as could be expected. The banking infrastructure has also greatly increased its penetration of rural areas and is well positioned to provide rural credit for large parts of the country. This could partly help in removing or atleast reducing the divergence or inter-state variations found in production yields of wheat, rice, cereals and pulses which indicates the existence of tremendous scope for further improvement in agricultural production. All these actually mean that the developments in Agriculture have increased the production potential of Indian Agriculture in a way which is not yet fully reflected in actual production.

Industrial Performance and Policies

The importance of industrialization as a means for achieving rapid growth has all along been recognized in the thinking on development strategy for independent India.

Indeed the objective has been not only to achieve rapid growth and prosperity within a framework of self reliance under the direction of the public sector, but to ensure that this is translated into improved conditions of living for the masses.

Over the last four decades covering the period since independence, the major achievements of the industrial sector were ;

1) Wide diversification of the industrial base so as to be able to produce a very broad range of industrial products.

2) development of a public sector with the potential to cater to the infrastructure needs of development and to provide direction to the process of development within a mixed economy framework; and

3) reduced and limited dependence on imports for the needs of development.

On the dismal side of industrial performance is the fact that despite massive investment, industrial growth has been comparatively slow. Since independence, India has made a laudable and generally increasing savings effort, with gross savings in excess of 20 percent of GDP after 1973-74. Much of this accumulated wealth has been directed towards investment in the industrial sector, with capital formation in manufacturing actually exceeding that in the entire agricultural sector in virtually every year in the last two decades. In the latter half of 1970s, investment in industry, excluding construction comprised 38 percent of all-domestic capital formation (Table 3). Yet despite very high levels of investment, industrial growth has been relatively slow with a trend growth rate in net production from registered manufacturing of some 4.5 percent between 1960-61 and 1980-81. Obviously this implies a sharp rise in capital intensity and indeed industrial value added relative to book value of fixed capital fell from 0.67 in 1959-60 to 0.39 in 1977-78 and has further marginally fallen to 0.38 in 1985-86 (Table 4).[1]

A large fraction of industrial investments - approximately 50 percent in 1970s and 45 percent in 1980s has been in the public sector. Yet the private sector continued to provide about 78 percent of industrial value added and 68 percent of employment by 1980s (Table 5) and (table 6). The package of policy instruments adopted to direct industrial development includes a plethora of extremely detailed controls, including industrial licensing, import quotas and wide-spread use of administered prices, intended to influence industrial performance through restrictions on market behaviour rather than relying upon incentives. The upshot has been an almost unique economic system of private ownership with widespread regulatory directives which caused inefficiencies slowdown in industrial growth.

1. This refers to the written down value of capital.

An important determinant of industrial performance in India is the performance of the public sector. The public sector today accounts for about 45 percent of the output of the organised industrial sector and 30 percent of total industrial output. Its size alone ensures that an overall acceleration of industrial growth would require an improvement in public sector performance (Table; 6). This is all the more so since the public sector occupies a dominance in key infrastructure industries such as power generation, coal, steel and crude oil production and hence performance in these areas is crucial to the general level of industrial efficiency. However, the record of public sector performance even in generating necessary surpluses for replacement of capital and for financing future growth is highly disappointing. It is found that many of the public sector units are chronic loss makers. The overall generation of resources from this sector is well below the levels assumed in the plan. The profitability in the public sector has been low for several reasons. Besides the low demand for many of its products arising out of cutbacks in public investment and some supply bottlenecks such as power, public sector profitability has suffered from uneconomic pricing policies and political interference in management. Public sector profitability is further eroded by its being saddled with a much larger labour force than is required and the unviable units which the government has been taking over from the private sector from time to time. Needlessly to say, each of these pathologies of public sector failure calls for its own solution. However, a census is emerging on one important issue, and that is the need to give management autonomy to public sector enterprises as a key requirement for efficient functioning. In a broader context, the policy initiatives for improving industrial performance involve a considerable measure of deregulation aimed at strengthening the more efficient domestic firms and encouraging them to invest and expand. The internal liberalization is to be accompanied by a policy of maintaining a sufficiently open access to imports to permit modernization and technological upgrading in Indian industry, which would reduce costs and promote international competition. As a matter of fact, there is no question of privitazation of the public sector. Instead the focus is on management and institutional reform of public sector to improve its efficiency.

Resource Mobilization :

An important aspect of performance, which has a direct bearing on the longer term growth performance of the economy, is the ability to mobilize resources for investment. The performance of the Indian economy in this dimension is commendable. The gross domestic savings rate which was 10.4 percent and 17.2. percent during first plan and fourth plan had increased to 20 percent by 1985-86 and 22 percent in 1986-87(Table 7). The rate of gross domestic investment in the economy, which increased only marginally from 17 percent in 1960-61 to 18 percent in 1970-71, then increased sharply thereafter to reach 24.7 percent in 1980-81. It has stayed around that level in the eighties (Table 7). The important point is that this high rate of investment is being financed almost entirely from higher domestic savings, testifying to the success of self-reliance in this sense of the term. Furthermore, an interesting feature of the increase in the aggregate savings rate is that it has occurred entirely because of the rapid growth in private household savings as a percent of GDP.. The ratios of private corporate sector savings and public sector savings to GDP have remained more or less constant at 2 percent and 3 percent of GDP respectively, while private sector savings increased from 12 percent of GDP in 1970-71 to 18 percent of GDP in 1985-86. This rapid growth reflects the cumulative impact of a conscious policy of giving strong incentives for private household savings, especially in the form of financial assets. Following nationalization of the Indian commercial banks in 1969, there was a massive expansion of the banking system spreading bank branches to all parts of the country, including also rural areas. The spread of bank branches definitely helped to mobilize private savings for investment in the organized sector. Interest rate policy was also geared to encourage household savings and for the past ten years or so, rates paid on term deposits with banks and other government sponsored small savings schemes have yielded positive real rates of return for savers, especially for maturities of three years and above. More recently positive real rates of return have been available even for shorter maturities. This favourable interest rate policy was reinforced by fiscal incentives for savings built into the direct tax structure which provide deductions from taxable income of the interest earned on a wide range of financial instruments.

Despite all these, however, two contrasting currents of thought mark the official documents and pronouncements on economic planning in India today. First, there is a sense of Euphoria and complacency at the near attainment of the growth rate envisaged in the sixth five year plan (1980-85) and also for the seventh five year plan alongwith relative stability of prices in recent years. Second, more importantly, financing of the seventh five year plan(1985-90) has been a major problem in spite of the sharp rise in the ratios of gross domestic savings and revenue collection to gross domestic product(from 10.2 percent and 6.83 percent at the begining of the plan period to around 23.0 percent and 18.5 percent at the end of the sixth plan and to around 20.2 percent and 19.0 percent by end of 1987-88), and the government is busy devising means for the mobilization of resources - with drives for stepping up tax collections, hikes in administered prices and large scale borrowing from the market by public sector enterprises.

Indian economy's efforts in respect of mobilization of savings appears commendable, but the steeprise in the savings and investment ratios has not been matched by similar increases in the rate of growth of the economy, there being nonperceptible trend in the overall rate of growth of the economy between the first five-year plan(1951-56), Sixth plan(1980-85) and 1987-88 (Table 7).

Inflation :

Inflation in India has been quite moderate by international standards, especially in comparison with the experiences of the Latin American countries. Measured by any of the three commonly used price indices - the gross domestic product deflator, the wholesale price index and the consumer price index - the average rate of inflation in India during the period 1951-1980 has been around 6 percent per annum, with the decades of the 1960s and the 1970s registering slightly higher inflation rates. The average inflation rate during 1981-89 has been around 7 percent per annum(Table 8). However, the modest nature of the average rate of inflation during the last three and half decades, however, hides three sub-periods of two digit inflation, namely, 1964-65 to 1967-68, 1972-73 to 1974-75 and 1979-80 to 1981-82. In India, price stability as an objective of economic policy has always been assiduously pursued and attended to by the policy makers and economic policies seem to have shown a strong systematic bias in favour of minimising inflationary pressures. This has led one to believe that India's macro-economic policies have been essentially conservative and cautious. Budgetary deficits at least until the 1980s have been kept to a very small proportion of GNP; when inflation has begun to climb, monetary growth has fairly soon been reduced with the desired effect; Indian economy has been able to reduce inflation very quickly in number of years and that too without any serious loss of industrial output. It should be noted that any movement in the general price level is usually accompanied by some adjustments in the inter sectrol price ratios. One single price which has been singled out as being of crucial importance for the growth potential of the Indian economy in general and of the industrial sector in particular is the relative price of Agriculture vis-a-vis of the other sectors of the economy. It has been argued that a movement in this intersectoral terms of trade has reprecussions on the allocation of investible surplus.[2]

It hardly needs to be stressed that the macroeconomic performance of the Indian economy could, by and large, be attributed to the specific stabilization policies followed and in this context, the behaviour of policy variables assume

2. Chakravarthy, S. (1974), Reflections on the Growth Process in the Indian economy, Foundation day lectore, series 7, Administrative Staff College of India, Hyderabad.

greater significance. An analysis and review of macroeconomic policies would seem to be useful for an insight into the specific way economic policies were administered and monitored in view of the state of the Indian economy prevailing at different time periods. The following section reviews the macroeconomic policies in India.

2.2 Indian Macroeconomic Policies - A focused review(1960-85)

Macroeconomic analysis is rather hard for a diverse and vast country like India. At any rate a simple model with few equations is unlikely to be meaningful. Hence something needs to be said about the meaning of 'macro-economic policy', and this is especially necessary for a highly controlled economy such as that of India. The range of policies here considered as 'macro' includes the conventional items of fiscal and monetary policy, the exchange rate regime adopted, and the management of the balance of payments. Governmental revenues and expenditures apart, these areas of policy all involve controls. In particular imports, the use of foreign exchange, borrowing abroad, foreign investment in India, interest rates, and domestic credit are alls subject to control. These controls both designedly and inadvertantly affect the allocation of resources to particular activities. One particular control measure which may on the face of it appears to be microeconomic in its effects is in fact a major instrument of macroeconomic policy, that is the handling of imports and stocks of foodgrains.

This is because, in India, the variability of the monsoon can be a more dominant influence than any change in the external environment.[3]

India exhibits none of the extremes of external shock and policy change, or of outcomes such as accelerated growth or lasting major recessions accompanied by large increases in unemployment, or inflation and debt servicing problems, features that attract swarms of economists to the study of the 'Southern Cone', Brazil, Mexico and Korea. But the absence of dramatic crises itself requires explanation, for there have been considerable disturbances. For instance, although external shocks were relatively small, not exceeding 3 percent of GNP in any year, India periodically suffers an internal exogenous shock from drought, which has caused a decline of agricultural production of as much as 15 percent in a year, and a 5 percent decline of GDP.[4]

India's macro-economic policies have been essentially conservative and cautious. Budgetary deficits at least until the 1980s. have been kept to a very small proportion of GDP. When inflation has begun to climb, monetary growth has fairly soon been reduced with the desired effect. Macroeconomic policy has thus been more Friedmanite than Keynesian. Foreign borrowing

3. Lance Taylor(1989) - 'Macro constraints on India's economic Growth', Indian economic Review, Vol.XXIII, No.2

4. Effect of external shocks is estimated by B.Balassa(1984) It means the reduction in exports on account of decline in World trade.

has been cautious, and capital movements strictly controlled. Apart from one devaluation in 1966, exchange rate policy has also been conservative; after the breakdown of Bretton Woods the rupee was pegged to the pound, and later to a small basket of major currencies (sterling remaining the currency of intervention).[5] When reserves proved inadequate, the balance of payments has been managed largely by variations in the stringency of import controls, but also by variations in borrowing.

India has in real terms avoided the most turbulent outcomes (except where loss of agricultural output is due to drought). But India has also grown slowly. This slow growth has not been uniform, but the trend has not deviated since 1950 from the 'Hindurate of growth', despite a strongly rising level of savings, and an increasing share of government in both output and investment, despite the 'Green Revolution', and despite the rise and fall of the influence of the Planning Commission. Would India have done better in the long-run if she had adopted Keynesian policies, used the exchange rate and interest rates, more actively as policy instruments, or borrowed more freely? Or would bolder macro-policies and free use of such 'Macro-prices' as the exchange rate and interest rates have made little difference to so highly controlled an economy? Alternatively,

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5. Intervention currency - the currency which the Reserve bank normally buys and sells; The Designation currency - the one in terms of which rupee's exchange rate is anounced; The Peg currency or basket of currencies - that in terms of which the value of rupee is kept fixed within a certain range.

if India had been much less controlled (and had therefore, most probably, grown faster) would she have been able to avoid the turbulance suffered by some more open economies?

Interesting questions are also posed by the apparent success of essentially monetarist policies. India was twice able in 1965-86 period to reduce inflation very quickly, and prima facie without very serious loss of industrial output or unemployment. This suggests considerable price and wage flexibility, and contrasts with the experience of many industrialised and Latin American countries. This is a matter that demands much more research than it seems to have been given. What were the costs of the monetary squeezes, and who bore them?[6]

India 1966-1985 : A Chronological sketch

This sketch is intended as background to the more focused albeit brief review of trends of monetary, fiscal and exchange rate policies that follow in later chapters.

From 1966 to 1970

The wars with China (1962), and Pakistan (1965) resulted in large increases in defence expenditure. It rose from around 2 percent of NNP before 1962 to around 4 percent between 1962 and 1972. Aid was suspended during the Pakistan war, and was resumed at a lower real level only after the devaluation of the rupee in 1966. The devaluation achieved little in the economic sphere, partly because of the disastrous droughts in 1966

6. Chopra has examined this issue for some developing economies including India and has reached conclusion that there are output losses, associated with monetary squeezes; Chopra Ajai (1985). 'The speed of the adjustment of the inflation rate in developing countries - a study of inertia', IMF Staff Papers, Vol.32, No.4, Pages 693 - 733, December.

and 1967.

The disastrous droughts, and the very large gaain imports of those years(food imports rose to about one-third of the import bill), did result in a shift of attention towards agriculture, increased agricultural investment, and rapid official acceptance and encouragement of the green revolution. From 1967-1971 net cereal production rose by about 50 percent. Agricultural recovery in India is often hailed as a new dawn, while its decline leads to despair and to ignorant foreign comment to the effect that India is a 'basket case', not worth aiding. NNP also staged a recovery growing at 5.5 percent p.a. in this period, though industry recovered only slowly from the recession caused by the drought year. This slow recovery may be partly attributed to the fact that in response to the inflation caused by the droughts of 1965-66 and 1966-67, the government imposed restrictive fiscal policies. The consolidated government deficit was reduced from Rs.173 crores in 1965-66 to Rs.46 crores in 1969-70. This, and the fall in aid, was associated with a fall on the transport and communication sectors, and also a fall in the trend of investment in electricity, gas and water supply. These 'economies' gave rise to shortage in these key non-traded sectors which have persisted ever since. It is noteworthy that the government preferred to cut investment rather than risk inflation by running budget deficits. It would surely have been better, had it been feasible, to maintain investment by augmenting public revenue.

From 1970 to First Oil Price Shock

The 1970s opened well, with a record harvest in 1970-71 low inflation (5.1 percent) and above average growth of GDP (5.6 percent). Overall government current expenditure rose by no less than 22 percent between 1970-71 and 1971-72, a period during which wholesale prices only rose by 5.6 percent, so that the rise in real expenditures was very large. Of the increase of nearly 233 crores rupees, less than 30 crores was for the defence budget, but provision for the refugees cost another Rs.32.5 crores(about Rs.12.5 crores was however recoupedfrom earmarked aid). It was not long before the economic situation deteriorated. Agricultural production fell in 1971-72, but was still above trend. The 1972-73 harvest was very bad, with an 8 percent fall in agricultural production(and a slight fall in GDP). The world price of wheat(and many other commodities) began a sensational rise in the summer of 1972. Unfortunately India delayed purchases finally buying less than the government had authorised, with the result that there was a fall in the availability of foodgrains in 1973. Money supply was allowed to grow rapidly, M_3 rising by 16 percent in 1971-72 and 18 percent in 1972-73. Food prices rose 16 percent between July 1972 and July 1973. The government nationalised the wholesale trade in wheat in the spring of 1973: This probably made matters worse, and the trade was again 'Privatised' in 1974. The spurt of inflation caused the authorities to initiate a policy of restraint in 1973, which became quite savage in 1974, when expenditure was cut, and taxes and interest rates were raised.[7]

With the new alignment of exchange rates between major currencies in 1971, India had to make a choice. Either luckily or cleverly(Ahluwalia,1985), a sterling peg was chosen: there was, however, very little movement in the real exchange rate from 1970 through 1974.[8]

From First Oil price shock to 1979

The preceding paragraphs make it clear that the oil shock was super imposed on an economy already suffering the economic and political trauma resulting from the very bad harvest of 1972-73, combined with, it appears, some mismanagement.

Expressed as a proportion of GNP, the deterioration in India's terms of trade was small compared to most other oil importing LDCs. But India is a low-trading country and the balance of payments effects were large. The current account changed from a small surplus of Rs.1301 crores in 1973-74 to a deficit of Rs.644 crores in 1974-75, the latter representing only .88 percent of GDP but 20 percent of the value of exports - this change could be accounted for almost entirely by the rise in the price of oil. There was no loss of reserves, as a result of an increase in aid and drawings on the IMF low conditionality

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7. Economic survey - issues of 1973 and 1974.

8. Ahluwalia M.S.(1985) "Balance of payments adjustment in India' 1970-71, Report to the Group of twenty four, UNCTAD.

tranches. After 1974-75 the current account turned round and was in surplus to the tune of over Rs.1526 crores in 1976-77 and remained in surplus until 1978-79.

This remarkable turn around from a deficit of almost Rs.644 crores to a surplus of Rs.1800 crores in two years was mainly due to a change in the reserves balance (Rs.1491 crores), supported by an increase in transfers (remittances) of nearly Rs.423 crores. Exports rose by 54 percent (31 percent in volume), and imports by 12 percent (nil in volume). Some additional export incentives were given, but the large change in the real effective exchange rate, a fall of 16 percent, was much more important. While there may have been some favourable non-price factors, it is hard to believe that the real effective exchange rate did not play an important role.

In a study of macro-economic management it is essential to ask to what extent the turn around was due to policy decisions or to natural equilibrating forces, or to luck. And where policy was involved, we also have to ask whether the policy measures with favourable outcomes were actually intended to produce those outcomes.

It was observed that in 1973 the government, alarmed by the price rises that were caused largely by the bad harvest but also by rising world prices, began to restrain the growth of the money supply. Prices continued to rise rapidly in 1974, and restrictive policies, both monetary and fiscal, were strengthened during the first half of the year. Public investment fell in real terms, and some non-fiscal restrictions on income growth were also introduced. These measures were supported by a good 1973-74 rabi(winter) harvest, and by increased imports of grain in 1974(5 million tons). The inflation came to a halt, and prices actually fall in the autumn, and continued their fall into 1975(despite rather poor harvests in calender 1975). The disinflationary policies were not, apparently, very painful. Industrial production which had scarcely risen from 1972-73 to 1973-74 rose by 3.2 percent, 7.2 percent and 9.6 percent in the following three years.[9]

The disinflationary policies had three obvious effects. First imports were restrained; and here the fall in public investment was probably of particular importance. Secondly, the 'pull of the home marker' was reduced, encouraging exports. Thirdly, and almost certainly most important the real exchange rate was devalued as India became less inflationary than the world. The disinflationary policies were set in motion to combat inflation, not to cure an unviable balance of payments. They began before the oil price shock. And when they were intensified in 1974, there was no very thretening payments problem. The current balance deficit of 1972-73 had been easily financed by an increase in aid,and low-tranche drawings on the IMF, with only a small use of reserves, and the same was true for the largest deficit of 1974-75. Other structural

9. Economic Survey(1989-90) Government of India, Ministry of Finance(Economic Division).

policies may have played some small role. The government did intensify the search for oil, but there was as yet little increase in output. There was also some increase in export subsidies, but the incentive effect was small compared to the real devaluation. Finally, however, the luck of the monsoon did play a role. The 1975-76 harvest was exceptional and huge stocks of cereals were accumulated(reaching 17 million tons by the end of the year). In 1975 imports of cereals had been higher (at 7.5 million tons) than at any time since 1967, but in 1976-77 they were vitually eliminated.

India was very slow and half hearted to make use of the large reserves of both foreign exchange and cereals that had accumulated, and continued to accumulate until the second oil price shock and the disastrous harvest of 1979-80. Imports were liberalised to some extent in 1976-77 and 1977-78, but the continued policy of almost total protection of Indian manufacturing prevented any upsurge. This may be a good example of how micro-policies can affect or inhibit macro-economic flexibility. However, money supply grew rapidly, fuelled by the rise in reserves. M_3 rose at over 20 percent p.a. between 1975-76 and 1978-79. It is a puzzle, needing further thought, that inflation remained low. India was criticised at the time for not using its large reserves, but it has to be noted that they came in very handy in the aftermath of 1979.

Imports did rise faster than exports, but the rising level of remittances kept the current account balance positive, albeit declining after 1976-77. It remained positive albeit declining after 1976-77. It remained positive until 1979-80. Aid fell sharply after 1976-77; it was after, all only going to swell the reserves which reached a level equal to more than nine months imports by the end of 1978-79. (IMF drawings were also repaid). The good harvest of 1977-78 resulted in some further accumulation of cereal stocks, which reached a level of net availability of 104 million tons in July 1979. Apart from liberalising imports, an increase in public investment would have been the obvious way of stimulating the economy: but central government capital expenditure stayed level from 1975-76 to 1977-78, and there was a consolidated government surplus taken over these three years.

Second Oil Price Shock, and Beyond

As in 1973-74 the oil price shock was a small proportion of GNP, and India was among the least affected of the oil-importing LDCs. Between 1978-79 and 1980-81 the resource balance deteriorated by Rs.43 crores. The current account deteriorated by less to about Rs.235 crores, mainly because of a further growth in remittances. The deficit was reduced only very slowly in the following three years, in sharp contrast to what happened after the first oil shock. As a proportion of exports these deficits were around 20 percent, as compared with the 25 percent of 1974-75. There was no such great turn around as after the first oil price shock.

The second shock, like the first, was imposed upon perhaps the worst harvest since independence, agricultural production falling by 15 percent in 1979-80 and GDP by over 5 percent. This caused food prices to rise by 7.0 percent in 1979-80 and 17.3 percent in 1980-81. These price rises were less than in 1973-74 and 1974-75, because some 14 million tons of cereals were released from stocks. There were no net imports, so the bad harvest did not significantly affect the current balance of payments. The wholesale price index, influenced also by world prices, rose more than food prices, by 17 percent and 18 percent in the same two years. The government's reaction to this inflation was much less fierce than to the earlier inflation. Only in 1981-82 did the growth of the money supply become less than accommodating, and inflation of the wholesale price index fell to an average of about 7 percent in the following three years - as against 2 percent in the three years after 1974. The consolidated government deficit which reached 3 percent of GDP in 1980-81 was reduced to 1.9 percent in 1981-82 and 1.6 percent in 1982-83. Further to this, public sector investment rose by 4 percent in real terms in 1980-81 contrasting with a fall of 14.5 percent in 1974-75; moreover it rose by about 10 percent p.a. in each of the following three years. Since 1982-83, various public finance indicators have deteriorated sharply. As a proportion of GNP, public saving has been falling, consolidated government and public sector borrowing has been rising and so has net reserve bank credit to government.

Thus on this occasion the adjustment of the balance of payments deficits was not primarily due to deflationary measures. Exports were relatively sluggish, rising by only 3.6 percent p.a. in real terms from 1978-79 to 1983-84. Though in large part due to a slowdown of world trade, it should also be noticed that exports received no boost from a depreciating real exchange rate, since on this occasion India's inflation exceeded that of its main trading counterparts and rivals. The real exchange rate appreciated by 14 percent between 1979 and 1981. This appreciation was slightly offset by various export incentives, but the contrast with the second half of the 1970s remains.

The behavious of imports was also different. After the first oil shock the volume of imports fell to a lower real level for three years, much the largest proportional fall being in capital good imports. In contrast there was a large rise in the volume of imports, especially capital goods, after the second shock. Comparing the three years before and after March 31,1980 the volume of imports rose by 50 percent, and capital good imports by 100 percent. The overall total was held down(relatively) by the successful import substituting 'adjustment' programme in oil. The volume of petroleum imports peaked in 1980-81. Between then and 1983-84, there was a 40 percent fall. India now imports about one-third of its oil, against two-thirds in the 1970s. The large rise in imports can be attributed to liberalisation, to the overall rise in investment, and to a greater public share of investment associated with very import and capital intensive 'adjustment' programmes of import-substitution in energy (oil and coal) and fertilizers.

It would be nice if the more expansionary policies of the 1980s, including the large rise in public import substituting investment, had resulted in some acceleration of industrial output. But industrial output rose at only 3.4 percent p.a. from 1980-81 to 1983-84. As a result ICORs[@] which fell after 1974 with expanding manufactured exports and production, have risen again to their highest levels.

How was the external deficit financed? In 1980-81 India drew Rs.8.15 billion from the IMF Trust Fund and the Compensatory Financing Facility: and in November 1981, it agreed to a very large Extended Fund Facility arrangement for SDR 5 billion over three years (about Rs.50 billion), only 3.9 billion of which had been used when India terminated the arrangement in May 1984. Apart from the IMF, concessional flows rose above the level of 1970s, and IBRD loans increased. Reserves were run down from their very high level, equal to nine months imports in 1978-79 to a 'normal' level of three months imports in 1981-82. Thereafter India resorted to commercial borrowing for the first time in any significant amounts and new commitments have recently risen to more than $1 billion a year. As of end 1984-85, the external debt to GDP ratio was 14 percent, still a low figure compared

@ Incremental Capital Output Ratio

to most developing countries. The terms of borrowing have hardened as the proportion of nonconcessionary loans have risen, but the debt service ratio was still at the modest level of 10.5 percent.

Recently the Economic advisory council[10] has provided its assessment of the current economic situation and has set out its suggestions in regard to priority areas for action. The report focussed on three aspects namely: 1) the growth prospects for the year 1989-90 (2) situation with regard to inflation and (3) the balance of payments position. On the basis of preliminary information available, the council inferred and predicted that growth of GDP in 1989-90 might not exceed 4 percent in real terms. The council has clearly pointed out that inflationary pressures have been particularly acute in certain essential commodities like sugar, gur, edible oils and tea and increase in prices of manufactured goods like textiles, paper, leather products was also noted. The report has identified the supply side factors like stocks of foodgrains and demand side factors like net RBI credit to the government, high fiscal deficits and spill over of fiscal imbalances into the growth of money supply. The report has noted that by 1988-89, the Balance of payments was under severe pressure and significant loss of foreign exchange reserves was being experienced. The short term pressures on Balance of payments were attributed to:

10. Economic Advisory Council(1989): Report on the current Economic situation and priority areas for action, December, Government of India.

a spill over of drought related imports of essential goods from 1987-88; strong demand for import generated by sharp recovery in production during the year; continuing high levels of fiscal imbalances and monetary growth; and high debt repayment/servicing obligations stemming from past borrowings.