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INDIA'S PATHWAY THROUGH FINANCIAL CRISIS

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Abstract

India survived near-crisis situations twice in the 1990s. What determined its ability to learn from the experience of a balance of payments crisis in 1991 to shield the economy from the pressures of the Asian financial crisis in 1997? By linking the two crises within a framework of external and internal economic and political constraints, the paper explains the dynamics of the crises. It argues that India's success can be attributed to five sets of decisions taken during 1991-97: devaluation, engaging the IMF, floating the exchange rate while increasing the central bank's autonomy to intervene against speculative pressures, opening up the external sector while maintaining asymmetric capital controls, and liberalising the financial sector. The paper analyses the options, political opposition and eventual outcomes for each set of decisions. Based on this approach it argues that India's ownership of its reform programme helped set the pace of reform while close interaction between technocrats and the IMF added credibility. But the balance between entrenched traditional interest groups and the demands of new interests determined the scope of reform. Finally, the paper raises broad political questions for the lessons other countries can draw from India's experience.

Introduction[†]

India survived near-crisis situations twice in the 1990s. In 1991 it was nearly bankrupt. In response a reform process began. But in 1997-98 the contagion of the Asian financial crisis again threatened India. Macroeconomic fundamentals were vastly different while political instability and external shocks were common in both episodes. So, the question is: what determined India's ability to learn from the experience of 1991 to shield the economy from the pressures of 1997?

Many in India viewed foreign investment and the international financial institutions with great suspicion. A highly regulated economy was considered necessary to keep control over limited economic resources and foreign interests. The experiences of dealing with the IMF and World Bank in the 1960s and 1980s had reinforced the sense that India should be self-reliant.

The Crisis

In 1991 India experienced a classic external payments crisis – high fiscal deficit, external borrowing to finance it, rising debt service commitments and resulting inflation, inadequate adjustments in the exchange rate and a deteriorating current account. From 1979 onwards the second oil shock, agricultural subsidies, and consumption-driven growth had pushed up the fiscal deficit. It further increased in the mid-1980s as defence expenditure was substantially increased and direct taxes were progressively reduced. The result was that from 1985 onwards the deficit ballooned to an annual average of 9 percent – by 1990-91 it was 9.4 percent of GDP (Acharya 2002a).

Two immediate external shocks contributed to the large current account deficit in 1990-91. First, Iraq's invasion of Kuwait in 1990 adversely exposed the Middle East's strategic relevance for India: it was vulnerable to shifts in global oil prices; hundreds of thousand Indians worked in the region sending home valuable foreign exchange. The Gulf crisis changed all that. Petroleum import costs in 1990-91 increased over 50 percent to \$5.7 billion.¹ The government had to bear the additional burden of airlifting and rehabilitating 112000 Indian workers – the largest civilian airlift in history – as remittances from the region declined.²

The second shock was the slow economic growth in India's export markets.³ Growth in the U.S. – India's largest export destination – fell from 3.9 percent in 1988 to –1 percent in 1991. Conditions in another major export market – the Soviet Union – had also worsened due to the oil shock. World growth had also declined from 4.5 percent in 1988 to 2.25 percent in 1991. Consequently, India's export growth was only 4 percent in 1990-91.

India was also suffering from internal political instability. The fragile National Front coalition faced a nationwide crisis in the summer of 1990 over its affirmative action policies,

[†] This paper has greatly benefited from interviews with Montek Ahluwalia, Manmohan Singh, Arvind Virmani and another former finance ministry official who wished to remain anonymous. Particular thanks are due to Shankar Acharya for critical comments and insights on an earlier draft. All errors and omissions are the author's alone.

with upper caste students taking to the streets. By autumn a political campaign by the BJP (an upper caste-dominated coalition partner) to build a Hindu temple at the site of a 16th century mosque in Ayodhya resulted in widespread communal violence. When the BJP's president was arrested in November the party pulled out of the government, thus bringing it down. A new minority government received the Congress's external support. But when this support was withdrawn in February 1991, the scheduled budget could not be passed. In the midst of campaigning for the general elections former Prime Minister Rajiv Gandhi was assassinated in May 1991.

In reaction, and in parallel, to these developments the economic situation worsened. By September 1990 net inflows of NRI deposits had turned negative. Access to commercial borrowing had become more costly and difficult and by December even short-term credit, particularly Bankers' Acceptance Facility, was restricted. Foreign exchange reserves fell to \$1.2 billion in January 1991. By the time a new government took over in June reserves could cover only two weeks of imports. India was close to defaulting on its sovereign debt for the first time in its history (table 1).

TABLE 1 Foreign exchange reserves (incl. Gold and SDRs) (US\$bn.)

1990-91	5.83
1991-92	9.22
1992-93	9.83
1993-94	19.25
1994-95	25.19
1995-96	21.69
1996-97	26.42
1997-98	29.37
1998-99	32.49
1999-2000	38.04
2000-01	42.28

Source: Ahluwalia 2002; RBI *Annual Reports*.

India's current account position had also worsened. An increasing dependence on foreign oil imports, vulnerability to oil price fluctuations, declining remittances from abroad, strong domestic demand (a result of liberalisation efforts in the mid-1980s and deteriorating fiscal balances), and rising interest payments on external debt contributed to a widening current account deficit which during 1985-90 it averaged 2.2 percent of GDP and was 3.1 percent of GDP in the year of crisis. India's export competitiveness had been adversely affected by a steady appreciation in the rupee's real effective exchange rate (REER): 20 percent between 1979 and 1986.⁴ From 1987 the rupee steadily depreciated but the real exchange rate remained overvalued until the year of the crisis.

In order to finance the fiscal as well as current account deficit India also relied on external funds. Foreign investment at an average of 0.1 percent of GDP during 1985-90 was a negligible source of foreign exchange. Instead, external assistance accounted for 0.7 percent of

GDP during the same period but during the 1980s this began to dry up.⁵ In the period 1980-85 nearly 50 percent of all external financing needs were met by external assistance. By the mid-1980s “aid weariness” forced the government to rely more on commercial borrowing.⁶ Consequently, external debt started dominating the balance sheet, peaking at 38.7 percent of GDP in 1991-92, with the debt-export ratio at 563 percent (Acharya 2002a). Moreover, short-term borrowings were a large proportion of total debt.

TABLE 2 Current account balance & external debt indicators (percentage)

	Current A/C balance as % of GDP	Debt Stock- GDP ratio	Debt- service ratio	Debt- Exports ratio	Short-term debt to Total Debt	Short-term debt to Forex Reserves
1990-91	-3.1	28.7	35.3	491.7	10.3	382.3
1991-92	-0.3	38.7	30.2	563.0	8.2	141.6
1992-93	-1.7	37.6	27.5	512.7	7.1	98.3
1993-94	-0.4	33.8	25.6	408.2	3.9	24.1
1994-95	-1.0	30.9	26.2	369.6	4.3	20.4
1995-96	-1.7	27.1	24.3	295.7	5.2	28.5
1996-97	-1.2	24.7	21.2	277.1	7.2	30.1
1997-98	-1.4	24.4	19.0	278.6	5.4	19.4
1998-99	-1.0	23.5	18.0	287.0	4.5	14.8
1999-2000	-1.1	22.0	16.0	258.6	4.1	11.5

Source: Acharya 2002a.

Notwithstanding the weakening fundamentals, one key factor that reduced vulnerability was the absence of private sector external debt. Unlike many other countries, individuals and firms could not raise foreign currency-denominated debt and the banking sector was not allowed to hold financial assets abroad. One effect of this was that the private industrial sector’s interests were more geared towards internal deregulation rather than support for external liberalisation.

In 1997 India was much less vulnerable, not just than it had been but than most East Asian economies.⁷ The current account deficit had fallen to 1.25 percent of GDP in 1996-97. External debt as a proportion of GDP (24.7 in 1996-97) was a fraction that of Indonesia’s (61.3), the Philippines’ (59.3) or Thailand’s (62.0). Short-term debt was 7.2 percent of total debt in 1996-7. The debt service ratio had fallen fourteen percentage points since 1990 to 21.2 percent in 1996-97, and the share of concessional credit remained at 40 percent. The banking sector – of which about 80 percent was state-owned – was also in a better position with non-performing loans only 8 percent of total loans. Moreover, while the crisis countries were often exposed to a common creditor country, this was not the case with India. The fiscal deficit, though high at 6.4 percent of GDP in 1996-97, had declined since the early 1990s.

The better fundamentals influenced expectations of crisis. In December 1996 the IMF calculated that East Asian countries had BoP crisis probabilities ranging from 25 percent for the

Philippines to 65 percent for Thailand. But India’s probability was just 11 percent.⁸ At the time India was experiencing some political instability. A minority coalition (United Front) government had come to power in summer 1996. But the Congress president, keen on regaining power, withdrew his party’s external support to the government in March 1997 (just over a month after a pro-reform budget had been tabled in the lower house). Hectic political negotiations resulted in a new Prime Minister being appointed, even as the UF government stayed in power. Less than a year later Congress withdrew support again, leading to new general elections. To add to the uncertainties, the two-month old BJP-led National Democratic Alliance (NDA) engineered nuclear tests in May 1998. The action invited widespread sanctions. Fresh commitments from the World Bank, Asian Development Bank and bilateral donors ceased. And credit rating agencies downgraded India, leading to outflows by foreign institutional investors (FIIs).

Against this background, India faced the East Asian crisis, which spread as far afield as Russia and Brazil. Speculative pressures on India persisted from August 1997 to February 1998. As a result of the nuclear sanctions, the pressures again increased from June 1998. Capital inflows sharply slowed down. The foreign exchange market was particularly volatile as the pressure on the rupee increased. Yet for all the pressures, India emerged relatively unscathed. By December 1998 foreign exchange reserves had reached \$27 billion and by end-1999 they were actually higher than in the pre-crisis period, standing at \$35 billion with a six-month import cover.

These stories set up the puzzle. Pressures arose both in 1990-91 and 1997-98 despite the different circumstances. So the answer to how India survived the crises must lie in the various policy decisions that were taken in the intervening period. Figure 1 summarises the web of constraints operating on policymakers. The question is how did these constraints shape the scope and speed of policy changes?

FIGURE 1 Constraints bred the crisis but made reform difficult

	External constraints	Internal constraints
Economic	Increase in external debt Declining concessional credit Increase in current account deficit & exchange rate overvaluation Volatile NRI deposits Contagion due to Asian crisis	Agricultural subsidies to rich farmers Industry’s demand for internal deregulation but external protection Rising fiscal deficit Declining foreign exchange reserves Rising inflation
Political	IMF consultations limited – seeking assistance risky; past agreements widely opposed Gulf crisis – oil dependency increases; workers’ remittances decline; need to airlift and rehabilitate Indians Demise of the USSR Nuclear sanctions	Parliamentary constraint over minority govt. Bureaucracy versus lateral entrants Organised labour in public sector Limited RBI autonomy & automatic monetisation of deficits Political instability in both periods

Key Decisions

India's economic policy-making can be illuminated by examining five key sets of decisions:

- Devaluation
- IMF programme
- A new exchange rate regime and changes in the RBI's role
- Carefully managed opening up to foreign investment
- Financial sector reform

Devaluation 1991

In 1991 with dwindling foreign exchange reserves India considered four options. The first was to default on the country's external obligations. The temptation was strong. It was an emergency situation and the country could have possibly justified its actions. But the action would have been almost self-fulfilling: given that since the previous December India was borrowing on a daily basis, market confidence had already eroded. A default would not have been a strategic act of hard bargaining; rather, it would have destroyed any remaining credibility. India had a history of repaying its debts on time. Policymakers did not want to sour that record. For a country obsessed with sovereignty, a default would have left it at the mercy of international institutions and creditors.

A second option was to seek private funds from abroad. But commercial borrowings had dried up and NRIs were themselves withdrawing their deposits – there was, in relative terms, a massive net outflow of \$1.3 billion during April-September 1991. Seeking their assistance was unrealistic.

Third, India considered using its gold reserves. This had some merit. In April the then caretaker government had raised \$200 million from the Union Bank of Switzerland through a sale (with a repurchase option) of twenty tonnes of gold confiscated from smugglers. Again, in July India shipped forty-seven tonnes of gold to the Bank of England in order to raise another \$405 million. This action showed India's commitment to repaying its international donors and creditors. Emergency bilateral assistance also came from Germany (\$60 million) and Japan (\$300 million).⁹

But India's problem was not the amount needed to avoid a default. Instead it had to shift away from recurring liquidity squeezes. India had to convince the markets that it was willing to undertake unpopular measures. Additional measures were needed.

Devaluation, however unpopular, had become necessary. Some Cabinet members disapproved. Even the President of India opposed such a move before a vote of confidence had been sought in parliament.¹⁰ In June 1991 Prime Minister Narasimha Rao appointed a former academic/bureaucrat, Manmohan Singh, as finance minister. Singh had served in all major economic positions in the country, including as RBI Governor. In the 1960s he had been doubtful of export-led growth strategies for India. Closer to the crisis of 1991 he had begun to believe that internal deregulation and external liberalisation had become necessary. As economic

adviser to the previous Prime Minister, Chandra Shekhar, Singh was not new to the crisis facing the economy. He determined that exchange rate adjustments, fiscal reform and influencing business expectations were the most immediate and necessary policy responses.¹¹ If the objective was to send signals to the markets, Singh’s appointment was a clever move. In order to minimise political opposition and institutional constraints, Singh implemented the necessary devaluation policy through the RBI rather than seeking cabinet approval; and he did it in steps. He instructed the RBI to announce new intervention rates. The RBI had been intervening to stabilise the fall in the rupee’s value since 1987. A lower rate of intervention signalled that the government was willing to let the rupee fall further.

The devaluation occurred in steps. On 1 July Singh wanted to “test the waters” before effecting any large change in the value of the rupee. Only when the markets reacted positively was a second devaluation permitted on 3 July. Overall, the RBI adjusted the rupee downward by 17.38 percent against the pound sterling.¹² Further, to counteract any inflationary impact the RBI increased the Bank Rate (the rate at which it lent to commercial banks), term deposit rates and the lending rate for large borrowers.

The fact that a minority government could engineer devaluation was itself a signal of credibility (figure 2). Rhetorical political opposition existed but institutional constraints were not a factor. Devaluation was an emergency step and needed political tact. But India’s 1966 experience had not to be repeated. Back then the IMF-backed devaluation led to tremendous political backlash. What mattered in 1991 were the follow-up policies and the people who executed them.

FIGURE 2 Devaluation was necessary but needed political tact

Options	Opposition	Outcome	Remarks
Default	No past history; bargaining power would decrease	Not a serious option – but helped to push case for devaluation	Devaluation was politically sensitive but Parliament was not involved in the decision; even Cabinet largely bypassed.
Seeking private funds	Not realistic – overnight rollover of debt; NRIs continued withdrawing funds	Attempted throughout 1990 but proved insufficient; market confidence not restored	
Use of gold reserves	Politically sensitive; only partially successful in previous attempt	Gold shipped to Bank of England to increase credibility	
Devaluation	Past experience poor; opposition from President and cabinet; fear of inflation	Two-step devaluation to ‘test the waters’	

The crisis gave an opportunity to pursue liberalisation, which some technocrats and private capitalists in India and NRIs abroad had been pushing for since 1989.¹³ The Congress party's manifesto had also reflected that demand. In the wake of the crisis widespread reform was proposed: industrial licensing for all except 18 industries was abolished; investment caps on large industrial houses were removed; only six industries remained exclusively in the public sector; access to foreign technology was liberalised; import licensing was virtually abolished; import duties were sharply reduced; and exporters could open foreign currency accounts.

A small team of trained economists led these changes. Singh developed a system of close coordination between the PMO, the Finance Ministry, the Commerce Ministry and the RBI. At the time the Economic Adviser in the Industry Ministry was Rakesh Mohan and the Commerce Secretary was Montek Ahluwalia, both of whom had worked for the World Bank. By late 1991 Arvind Virmani had been shifted to the Finance Ministry as Economic Adviser while Ahluwalia became Secretary, Department of Economic Affairs. Ashok Desai, an Oxford-trained academic, became Chief Consultant and Raja Chelliah, public finance expert, was made an adviser at the rank of minister of state. In 1992 another advocate of reforms, C. Rangarajan, was appointed RBI Governor.¹⁴ And in 1993, Shankar Acharya was called in from the World Bank as Chief Economic Adviser. Technocrats were beginning to dominate the upper echelons of the bureaucracy.

Their induction into the bureaucracy in high positions meant that an opportunity now existed for the IMF/World Bank to interact with like-minded policymakers at the highest levels of decision-making in the country.

IMF Programme 1991-93

Since the devaluation worked, why was the IMF approached? In financial terms, the IMF's assistance was relatively minor – in 1991-92 withdrawals from the IMF amounted to \$1.2 billion as against the India's short-term debt of \$6 billion at the end of 1990-91, with overnight borrowing in international capital markets to the order of \$2 billion. India's decision to seek an IMF programme requires some explaining.

Interviews with senior finance ministry officials revealed that informal proposals were made as early as September 1989 to approach the IMF. But elections due in November give at least one reason why negotiators could not have made commitments back then. More generally there was ideological opposition to engaging the IMF. Once the National Front government assumed office Finance Minister Madhu Dandavate declared in his budget speech (February 1990) that "the fiscal imbalance [was] the root cause of the twin problems of inflation and the difficult [BoP] position."¹⁵ A year later another Finance Minister, Yashwant Sinha, admitted that the government had realised the economic situation was of "crisis proportions" by November 1990 itself.¹⁶ Between July and September 1990, the National Front government drew \$660 million from its Reserve Tranche in the IMF. By end-1990 when reserves could cover only three weeks of imports, India negotiated the purchase of \$1.8 billion under the IMF's Compensatory and Contingency Financing Facility (to cover oil imports) and the first tranche of a stand-by agreement. The CCF was an emergency measure and had very low conditionality attached to it. However, harsh steps were taken to compress imports: higher cash margin requirements,

surcharges on petroleum products and on interest on import credit, and tightened import licensing.

Initial policy reforms pushed by the technocrats occurred before India approached the IMF. There was a strong belief among policymakers that emergency stabilisation had to be accompanied by medium-term structural adjustment. India had orthodox objectives: shifting resources from the non-traded to the traded goods sector; promoting exports; liberalising imports; and reducing state intervention in economic activity and the scope of the public sector. In sum: economic policy had to undergo “a transition from a regime of quantitative restrictions to a price-based mechanism [and less] bureaucratisation...”¹⁷ What differentiated India was its desire to approach these changes in gradualist fashion.

The IMF was approached to underwrite the reforms. Under the CCFF agreement India had already withdrawn \$221 million and \$637 million in July and September 1991, respectively. With more wide-ranging reforms being announced, additional support was sought. The RBI's Annual Report explained that the stabilisation measures would take time to have an effect on foreign exchange reserves. It estimated that external financing of \$3 billion was needed to “undertake reforms without undue disruption”.¹⁸ India's Letter of Intent to the IMF outlined its proposals for policy reform.

And India largely got what it wanted. In a November 1991 stand-by agreement the IMF promised to provide \$2.2 billion over a period of twenty months. Both sides also expected that this arrangement would have to be followed by concessional loans under the Enhanced Structural Adjustment Facility (ESAF). In addition, the Aid-India Consortium committed aid up to \$6.7 billion.

In comparison to previous episodes, India's relations with the IMF from 1991 onwards were unique in three ways. First, some groundwork had already been laid since late 1990 that indicated possible reforms in the economy. Of course, there were differences of opinion on the extent of engagement and nature of conditionality. But it at least indicated that the need for reform was acknowledged. Political instability had stalled difficult decisions earlier. Now, the new government was carrying the process forward.

Second, the IMF was now dealing with senior policymakers who had similar views on the direction of economic policy. Because of their previous experience in multilateral institutions, policymakers could now rely on their networks in the World Bank and IMF to provide information about policy options (for example, in how to deal with capital surges; discussed later).

Third, there was greater interaction with the IMF's management team. The crisis was not one of strategic interest for the G-7 countries.¹⁹ In 1966 (at the peak of the Cold War) ensuring that India did not remain a closed, socialist economy was an important objective – America had directly and indirectly applied pressure to secure trade liberalisation measures, which eventually failed. In 1991, there was no coordinated G7 pressure.²⁰ The relationship was now more technocratic and less political.

But internal political constraints remained. Opposition parties accused the government of surrendering India’s sovereignty to the IMF, even suggesting that the February 1992 budget had been whetted through the IMF beforehand. While Parliament did not have to sanction agreements with the IMF it did have to pass the budgets that incorporated these policies. Singh insisted that the only conditionalities that India accepted were the ones that it had proposed.²¹ But the government was in a minority. There was no certainty that the budget would be passed.

As it turned out, the budgets of 1991, 1992 and 1993, which laid out the core elements of economic reform, were passed. The reason lay in India’s shifting political cleavages.²² From two seats in parliament in 1984, the Hindu nationalist BJP had risen to become the second largest party in 1991 with 120 seats. Due to the Congress’s historical dominance politics in India had been largely bipolar with all other parties (the left and regional ones) forming the opposition. The advent of the BJP made politics “triangular”. For the left parties and the lower caste-dominated Janata Dal the Congress’s decline meant that the BJP, with its highly divisive communal agenda, was a bigger threat. As one scholar puts it, they “disliked the reforms, but *they disliked Hindu nationalism even more*”.²³ In order to block the reforms and bring down the government these parties would have to ally with the BJP, which was anathema to them. Identity politics, not economic ideology, determined political coalitions.

But the IMF relationship did not last long. Table 3 shows that there was no extension of the IMF Standby Arrangement beyond 1993. There were, of course, positive signs in the economy: foreign exchange reserves had climbed to \$9.83 billion by the end of 1992-93 and economic growth had recovered to 4 percent. It was a “sign of strength” for India to be not dependent upon external assistance.²⁴ But there might have been other considerations as well.

TABLE 3 Drawings under IMF Standby Agreement 1991-93 (US\$ million)

Date	Amount
November 1991	117
January 1992	263.59
July 1992	663
December 1992	643
February 1993	319
June 1993	325

Source: RBI 1992, 1993.

Fiscal deficits, a key source of weak macroeconomic fundamentals, were much harder to control. All former officials interviewed claimed that this was one issue on which the IMF demanded more than India could deliver. In addition to the special interests benefiting from subsidies, the government was also wary of the highly inflation-sensitive Indian public. Wage and price rigidities in the economy would have made adjustment to sharply reduced fiscal deficits much more painful. For the first two years after the crisis, and while India was still part of the IMF stabilisation programme, the fiscal deficit was brought down to 7 percent. In 1993-94 the deficit rose again. The deficit worsened after 1996-97 and by the end of the decade it was larger than in 1991.

Internal political pressures were dominant. Another IMF programme would have meant further expenditure cuts that were politically infeasible for the government. Once the external pressure eased, expenditure rose as well. Food and fertiliser subsidies, aimed at keeping poor households and farmers happy, rose 72 percent during 1991-97. Their share of explicit central government subsidies also rose in the initial years of reform, from 56 percent in 1990-91 to 91 percent in 1995-96.²⁵ Another key factor was the rise in government salaries as recommended by the Fifth Pay Commission. Moreover, state governments pursued populist policies resulting in worsening deficits.²⁶

These developments reflect a repetition of the 1980s experience. Traditional interests in agriculture and the public sector prevented fiscal correction (figure 3). The experience also drew a distinction between policies that were technical in nature (extent of devaluation) and policies that directly threatened subsidies, employment or social expenditures.

FIGURE 3 Constructive but limited relationship with the IMF

Options	Opposition	Outcome	Remarks
Emergency credit – IMF had assisted in the past	Political sensitivity against seeking IMF's help	CCFF negotiated in early 1991 – low conditionality	Parliamentary support for IMF programme not automatic; but
Stand-by agreement – needed for support to reform process	Conditionalities would be more; accusations of IMF-drafted budget	Agreement signed largely on proposals forwarded by India	greater enemy were Hindu nationalists.
Continuing IMF programme beyond 1993	Would have imposed greater fiscal constraints	Decision not to continue based on improved reserves position & growth indicators; but fiscal deficits also increased.	Nature of interactions with IMF now markedly different from the past. Fiscal deficits not a technocratic decision but function of multiple political pressures.

Exchange Rate Regime & RBI's Experience 1991-96

A third critical choice made by India in 1991 was about the exchange rate. Until 1991 the rupee was pegged to an undisclosed basket of currencies and the Finance Ministry determined the band within which it would allow the currency to fluctuate. After India devalued the rupee in July it had three options: persist with an administered peg at the new rate; immediate transition to a market-determined exchange rate; or a phased liberalisation of the regime.

An administered peg was no longer feasible. The pegged rate failed to depreciate fast enough through the late 1980s. It was one of the reasons behind the high current account deficit, lack of export growth and dwindling foreign exchange reserves. In the aftermath of the crisis, persisting with an administered rate would not boost market confidence.

There were clear advantages in having a market-determined rate. First, it would ensure that an overvalued exchange rate did not hurt exports, especially when trade policy was being liberalised. Second, it would minimise rent-seeking activities by eliminating the black market in foreign exchange. Third, the RBI could focus on monetary policy to control inflation, rather than rely on overvalued exchange rates.

But there was a downside as well. India had experienced volatile markets. Given the persistent foreign exchange constraint, it could not afford to lose reserves to speculative attacks or fluctuations in the exchange market. Another crisis would have also undermined the nascent reform efforts. Moreover, it would have adversely affected the fiscal situation. The stabilisation of July 1991 had involved devaluation and a sharp contraction in government expenditure. But market-determined rates would have meant a greater fiscal burden on defence and administrative imports and debt-service payments. It was preferable to pay for these with foreign exchange surrendered at the official rate.²⁷ These considerations informed the RBI's objectives: to reduce volatility in the exchange rate; to maintain an adequate level of foreign exchange reserves; and to help create a market for foreign exchange.²⁸

Thus, India opted for phased liberalisation. In March 1992 a dual exchange rate regime – the liberalised exchange rate management system (LERMS) – was introduced. Under this 40 percent of export earnings and remittances were to be surrendered at the official rate with the remaining being converted at market rates. The system taxed exporters in order to subsidise government-related imports. The Department of Economic Affairs in the Finance Ministry set up a committee with RBI and Commerce Ministry representatives to monitor the system. Initially, the scheme was to run for two years while the BoP situation improved. But with rising foreign exchange reserves and improving growth rates policymakers deemed a quicker end to dual rates – within a year of instituting the scheme, in February 1993 the rates were unified and became market-determined.

A new role for the RBI accompanied the new policy. The RBI might have been granted statutory independence to ensure that the central bank would not be encumbered by past practices of having to monetise deficits. But this was never a realistic option. Manmohan Singh himself noted that independence of the central bank could be conceived only in economies where factor mobility was high, structural rigidities were low and the government had many other

instruments to affect economic activity. This was not the case in India; the RBI could not be unmindful of the economic environment of the country.²⁹ That said, some important institutional changes were made.³⁰

The government started phasing out the use of *ad hoc* Treasury bills from 1994 onwards. This ensured that the government would have to finance its needs by borrowing in the market, thus creating an incentive to improve its balances. In order to ease short-term liquidity problems the RBI raised the limits on the Ways and Means Advances of state governments. Moreover, the RBI gained a degree of autonomy – the exchange rate was no longer in the hands of the Finance Ministry. This was made possible by the close coordination and understanding between senior officials in the RBI and the Ministry.

More importantly, the RBI gained experience in handling volatility in the foreign exchange markets, in terms of large capital inflows. Between September 1993 and October 1994 India experienced a surge in capital inflows of \$12.2 billion.³¹ On the one hand, it was a sign of growing confidence in the Indian market. On the other hand, temporary flows increased the economy's vulnerability. Policymakers were uncertain whether the surge was permanent and therefore hesitant to allow a nominal appreciation that could undermine export competitiveness.

RBI and Finance Ministry officials considered various options: relaxing trade restrictions so that inflows could finance additional imports; relaxing restrictions on capital outflows; introducing quantitative restrictions on inflows; or intervening in the markets combined with sterilisation.³² But options were limited. Relaxing trade restrictions was politically difficult. Institutional changes to permit outflows were risky if the flows turned out to be temporary. Conversely, restrictions on inflows would have limited the ability to build reserves, a primary objective of the RBI since 1991.

Hence, contrary to IMF advice, the RBI accumulated foreign exchange reserves while partially sterilising its impact by increasing reserve requirements and selling government securities.³³ The high fiscal deficit restricted the RBI's ability to fully sterilise the inflows. But it ensured that neither export growth nor the ongoing investment boom was hindered.

The RBI's new role did not develop unmindful of either the institutional constraints (the demand of state governments for deficit financing) or the policy objectives in the reform period (export-oriented growth) (figure 4). This experience was to prove crucial in confronting the Asian crisis. The RBI's actions also served as a signal to the markets as well that it was unwilling to allow irrational volatility in the exchange rate.³⁴ The question was whether similar interventions could be successful in the case of capital outflows.

FIGURE 4 Gradual changes in exchange rate management

Options	Opposition	Outcome	Remarks
Administered peg	Had failed through 1980s – cause of rising CAD	After devaluation, this regime had to be abandoned	Changes in the E.R. regime had been discussed before (several Planning Commission papers). Parliament's approval not required. Nor were entrenched interests deeply affected, while exporters and importers benefited.
Free-float – would help exports; reduce black market; depoliticised	Risky due to volatility; would hurt fiscal deficit	Not attempted	
Gradual approach	Unorthodox policy; implicit tax on exporters; could affect credibility	EXIM scrips in 1991; LERMS in 1992; unified exchange rate in 1993, sooner than planned	
RBI autonomy	Rigidities in the economy could not be ignored – independence out of the question	Greater autonomy – Finance Ministry no longer setting the band	Close coordination between Finance Ministry & RBI helped to mitigate bureaucratic opposition.
Market interventions	Would undermine credibility; IMF opposed intervention	Cautious approach to capital surge; partial sterilisation to control inflation	Capital surge episode showed that IMF was not forcefully imposing its views.

Carefully Managed Opening up of the External Sector

One major lesson from the 1991 crisis was the danger in excessive external debt. The government took early steps to rectify the situation. A High-Level Committee on Debt Management produced its first report by October 1993. From this evolved a new institution, the External Debt Management Unit, which would monitor the management of external debt. The new debt strategy sought to: reduce short-term debt; impose annual caps on medium-term debt; encourage non-debt creating flows; and encourage growth of exports. Not only did this strategy reduce the stock of total debt but also dramatically reduced short-term debt as a proportion of foreign exchange reserves: from 382 percent in 1990-91 to 19 percent in the year of the Asian crisis (table 2).

Another related lesson learnt was the need to build up foreign exchange reserves that would fulfil three criteria: adequacy (cover for short-term debt and current account deficit); liquidity (for use in emergencies); and transparency (of purchases and sales, including forward contracts).³⁵ Adequacy of reserves was sought by deliberate accumulation (as in the RBI's

intervention in 1993-94) and reduction of short-term debt. Further, India took preventive steps to maintain liquidity by issuing bonds to NRIs through the State Bank of India – the Resurgent India Bonds in August 1998 (in response to the nuclear sanctions) raised \$4.2 billion and the India Millennium Bonds in October 2000 yielded \$5.5 billion. Finally, the RBI published foreign currency transactions, including net forward positions, on a monthly basis, thus conforming to the IMF's Special Data Dissemination Standard.

In respect of foreign direct investment, the government also made changes. Starting with thirty-four industries, the foreign direct investment (FDI) regime was liberalised in 1991.³⁶ Controls on portfolio investment were eased in September 1992 when FIIs were allowed to invest in the secondary market, soon followed by permission to invest in the primary market as well. In fact, India was one of the first emerging economies to open its equity market to portfolio investments. From 1996-97 FIIs could also invest in government securities.

There were obvious attractions. Raising equity flows could help to alleviate the foreign exchange constraint. Moreover, equity capital could also help develop the domestic equity market and increase resources for investment. Finally, it was hoped that fast-responding flows would disseminate information about market opportunities in India, thereby attracting more stable FDI.

In August 1994 India introduced current account convertibility. The decision was taken in response to the recommendations of the High-Level Committee on Balance of Payments 1993 (chaired by RBI Governor C. Rangarajan).³⁷ But the Committee also cautioned against “capital flight through liberalised windows of transactions under invisibles”. The government feared large capital outflows in the guise of current account transactions. So, it maintained regulations on such transactions. Indicative limits were placed on the value of different types of current transactions. Steps were taken to prevent the dollarisation of the currency. Thus, dollar-denominated transactions between residents and offshore rupee transactions were prohibited.³⁸

This was another example of phased liberalisation, which followed the changes in the exchange rate regime. Current account convertibility meant accepting Article VIII of the IMF's Articles of Agreement, giving up its right to transitional arrangements. The IMF urged the government to remove exchange restrictions under Article VIII “as quickly as possible”.³⁹ Yet, outside of a formal arrangement it had limited influence.

In June 1997, the Tarapore Committee on Capital Account Liberalisation recommended a three-year phased plan for introducing capital account convertibility (CAC) in India. It outlined preconditions for CAC: lower fiscal deficit; targeted inflation rate; deregulation of administered interest rates; reduction in banks' non-performing assets; monitoring the exchange rate within a declared band; and creating a level playing field for participants in the financial system.

Compared to the concern in the early 1990s about volatile capital flows, the Committee's recommendation was path breaking. But it should not have been a surprise. Foreign exchange reserves were rising. With current account convertibility and the increasing importance of the services sector in the Indian economy, it was increasingly difficult to distinguish current from capital account transactions.⁴⁰ Thus, the Committee's terms of reference asked it to recommend

measures and specify the sequence for achieving convertibility.⁴¹ The question was not whether but *how* to achieve CAC. Yet this was not entirely a technocratic decision. Private interests were also in favour.

Three groups had emerged since 1991 with an interest in convertibility. First, FIIs wanted the freedom both to invest in an emerging market like India, which offered high interest rates, and also to withdraw funds at will. Theoretically, free capital movements could offer a substitute for debt-creating flows. Also, policymakers expected that FIIs would have a longer-term view than individuals.⁴² Second, NRIs wanted to invest in the home country. At the same time they did not want to be constrained by limits on capital outflows. The government would have to offer appropriate incentives for attracting investment.⁴³ Third, there was an emerging domestic constituency that wanted to benefit from freer capital flows – companies could raise capital abroad and individual investors could benefit from investments in foreign markets. This constituency had largely developed due to the liberalisation of the domestic stock market: between 1990 and 1997 stock market capitalisation had increased six-fold.⁴⁴

The new interests did not directly threaten the older sector-specific interests. With greater RBI autonomy even the bureaucracy's control over exchange rate policy had been weakened. Capital account liberalisation did not need parliamentary approval either.

But the Asian crisis exposed the dangers. Pressures on the rupee increased from August 1997. In May 1998 nuclear sanctions added to the instability. In keeping with its earlier experience, the RBI massively intervened in the forward market: outstanding forward sales of foreign currencies increased from negligible levels in August 1997 to \$3 billion in January 1998.⁴⁵ The six-month forward premium increased from 3.6 percent in July 1997 to 14.6 percent in February 1998. The RBI also followed a tight money policy from November 1997 to control inflation, with a two-percentage point hike in the bank rate and increased reserve requirements. Despite these interventions, between end-September 1997 and end-June 1998 the exchange rate depreciated 16.7 percent.⁴⁶

Yet, the impact was not severe. The GDP growth rate dipped to 4.8 percent in 1997-98 but rose again to a healthy 6.5 percent in 1998-99. Foreign reserves remained high in comparison to other crisis countries. Portfolio outflow in the first three quarters of 1998-99 amounted to \$689 million but in the last quarter it was almost completely reversed with inflows of \$621 million. Even the current account deficit fell to just 1 percent of GDP in 1998-99. The Asian crisis was a mixed experience. It reminded policymakers of the dangers of capital account liberalisation but also showed that capital controls had a significant role in checking speculative crises.

The crisis informed policy developments. Since 1991 India has had asymmetric controls on capital transactions – fewer for inflows, more for outflows.⁴⁷ While Indian firms were allowed to raise funds in international markets through global depository receipts from September 1992, international commercial borrowing was highly regulated. None of these measures required Parliament's assent. The bulk of borrowing required case-by-case approval from the RBI depending on the amount, maturity and end use. Commercial banks were not allowed, until very recently, to accept deposits or extend loans denominated in foreign currency, except for NRI deposits and exporters' accounts.

Capital outflows were gradually liberalised. The Tarapore Committee recommended that flows on individual accounts should be liberalised first. In fact, outflows were made easier for corporate entities and financial intermediaries but not for individuals.⁴⁸ Individual Indian residents were not allowed to acquire financial assets abroad. Indian firms could invest abroad for global expansion purposes but were not allowed to hold foreign financial assets. FIIs were allowed to repatriate the principal, interest and capital gains. But short-term capital gains were taxed at a higher rate than for domestic investors.

Capital controls prevented excessive dependence on foreign credit; they also barred excessive capital flight. Controls against external borrowing minimised banks' exposure to regional foreign exchange risk. The political economy of controls reveals that the government tried to create a mechanism to attract foreign investment from specific sources while restricting capital transactions for other entities (figure 5).

FIGURE 5 Capital controls protect against the contagion

Options	Opposition	Outcome	Remarks
Debt versus capital inflows	Portfolio inflows had high risk of volatility	EDMU set up to monitor debt; FIIs allowed to invest from 1992	Again, neither Parliament nor entrenched interests deeply affected by this.
Current account convertibility	With increasing volume of transactions, even current account transactions could involve large outflows	Adopted with qualifications; recommended by Rangarajan commission; improved reserves position	But new interests – FIIs, NRIs, industry demands – could not be ignored.
Capital account convertibility	Very risky; Asian crisis exposed the dangers	Asymmetric capital controls – easier for inflows, for FIIs, and for corporate entities	Asymmetric controls helped attract inflows while insulating against large-scale outflows.

Financial Sector Reform

Despite capital controls financial sector weaknesses can add to external vulnerability. Banking and capital market reforms were initiated soon after the crisis in 1991. Some attempts were more successful than others. These developments are briefly analysed below.

Limited changes in banking

As noted earlier, prohibitions against foreign asset ownership by Indian public sector banks had been one mitigating factor in the early 1990s. With increasing capital mobility even

internal weakness in the banking system could be cause for concern. The report of the Narasimhan Committee on the Financial System (November 1991) highlighted this problem in its recommendations.⁴⁹ Keeping in line with other policy issues, in April 1992 it was decided to implement the Committee's recommendations in a phased manner.

Banking reforms were widespread in the 1990s⁵⁰: removal of interest-rate ceilings and credit authorisation requirements; reduction of cash reserve ratios and statutory liquidity requirements; dilution of 100 percent government ownership of public sector banks; establishment of a Debt Recovery Tribunal; adoption of Basel I prudential norms to fix capital-to-risk-assets ratio and disclosure requirements. The new accounting norms exposed the weakness of the system. Of the 28 public sector banks, 26 declared net profits in 1991-92; only 15 did so in 1992-93.⁵¹

But the reforms were only partially successful. Net non-performing assets of public sector banks declined from 9.18 percent in 1997 to 6.74 percent in 2001, but were still much higher than the international norm of 2 percent.⁵² Moreover, the banking sector continued to remain largely in government control. Though ownership was diluted, complete privatisation was never an option. Bank lending was a tool of industrial policy in India, as well as for ensuring equitable growth. Hence, the objectives of priority lending and protection of depositors' interests were dominant (even though it was dependent on the guarantee of regular recapitalisation of failing banks). But the more important reason was labour opposition: public sector banks had 880000 employees in 1992 (up from 650000 in 1982),⁵³ and privatisation or even greater efficiency would have required some degree of retrenchment. Once again, technocratic decisions were easier to enforce while entrenched interests were much harder to target.

But institutional successes for capital markets

Capital market reforms were more noteworthy. They started with a Presidential Ordinance in January 1992 establishing the Securities and Exchange Board of India (SEBI) as the regulator. Until then the Controller of Capital Issues had been part of the Finance Ministry. Instead, SEBI was an independent statutory body. The Ordinance allowed the government to bypass parliament for a maximum of six months, which was eventually followed up with a SEBI Act in the same year.

This was followed by the incorporation of the National Stock Exchange (NSE) in November 1992 as a public sector undertaking. Despite reservations about the government's ability to spawn a new organisation, the NSE was a success. In contrast to the hitherto monopolistic Bombay Stock Exchange (BSE), the NSE became the most liquid stock market in the country within a year and introduced several modern features including electronic trading in 1994 and derivatives trading in 2000-01.

These developments were in response to a series of stock market crises throughout the 1990s.⁵⁴ At the time of its inception, SEBI had limited supervisory capacity. But the NSE's advent shifted the political economy of the securities markets. A market design based on new technology could keep the market more liquid and minimise opportunities for fraud. Stock market crises, driven by manipulative yet entrenched brokers, were affecting small investors.

NSE's shareholders were large mutual funds and banks (UTI, IDBI). These, in turn, represented the interests of millions of households, which had been investing in the markets since the 1980s. Together with new brokerage firms, this was a new constituency that could oppose the stockbroker-dominated clique in the BSE.

Both banking sector and capital market reforms set in motion institutional changes that were necessary for reducing external vulnerability (figure 6). Despite their uneven record, in comparison with East Asian countries India's financial sector would have been a source of market confidence.

Alongside India's careful opening up to foreign investment, in the 1990s the government introduced some modest reforms to the banking system, including⁵⁵: removal of interest-rate ceilings and credit authorisation requirements; reduction of cash reserve ratios and statutory liquidity requirements; dilution of 100 percent government ownership of public sector banks; establishment of a Debt Recovery Tribunal; adoption of Basel I prudential norms to fix capital-to-risk-assets ratio and disclosure requirements. The new accounting norms exposed the weakness of the system. Of the 28 public sector banks, 26 declared net profits in 1991-92; only 15 did so in 1992-93.⁵⁶ The results were not dramatic. The banking sector continued to remain largely in government control. The objectives of priority lending (as a tool of industrial policy) and protection of depositors' interests remained dominant, and labour opposition by some 880,000 employees in public sector banks (in 1992, up from 650,000 in 1982),⁵⁷ prevented any more radical change. In short, technocratic decisions were easier to enforce while entrenched interests were much harder to target.

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FIGURE 6 Institutional reforms in the financial sector

Options	Opposition	Outcome	Remarks
Removing controls on banks – government committee recommended	No particular opposition	Many controls were removed but prudential norms also instituted	Banking reform was mixed success (technical issues easier) but labour-bureaucracy nexus remained powerful.
Privatisation of banks; improving asset base	Ideology of government allocation of credit dominated; large banking sector workforce	Some dilution of ownership occurred but privatisation not an option.	
Introducing regulatory institutions for capital markets	Would reduce Finance Ministry's control over capital markets	SEBI established as statutory authority	Capital market reforms succeeded because of new technology, development of new class of interests and eroding power of manipulative brokers.
Alternative stock exchange	Doubts over government management; BSE dominant institution under control of brokerage houses	NSE introduced new technology and new products – huge success	

Who Pays?

India's experience was different from other countries in this study in the sense that its private sector was barely exposed to the volatility of international markets. The public sector dominated banking system did not have overseas liabilities. Private firms and individuals did not owe large sums to international creditors. FIIs were not barred from withdrawing deposits. And since India largely averted the two crises of the 1990s there were no bankruptcies or debt defaults. Nevertheless, crisis management did have some immediate adverse implications. The burden of adjustment fell on inflation, poverty incidence and social sector spending.

India is an inflation-sensitive country. The period 1991-96 was a period of sustained double-digit inflation (see table 4). The BoP crisis demanded a sharp contraction in imports,

which adversely affected industrial production. Combined with poor agricultural performance, the resulting output contraction pushed up inflation to nearly 14 percent in the crisis year. There are alternative explanations of the persistent high inflation until 1996. One argument traces rising inflation to the capital surge, from 1993 onwards, inadequate monetary sterilisation and unwillingness to throttle an investment boom.⁵⁹ By contrast, critics of the stabilisation measures blame the nature of fiscal adjustment. It is argued that sharp reductions in subsidies on fertilisers or the rise in user-charges for utilities like electricity fuelled cost-push inflation as basic commodities like food and energy became costlier.⁶⁰ In reality inflation was a combination of all these factors. To the extent that the prices of wage goods increased the immediate impact of the stabilisation experience would have fallen on the poor.

TABLE 4 Inflation in the 1990s

	WPI(AC)	WPI(MP)	CPI(IW)
1991-92 to 2000-01	7.8	6.6	8.7
1991-92 to 1995-96	10.6	10.2	10.2
1992-93 to 1995-96	9.8	9.9	9.4
1996-97 to 2000-01	5.0	3.1	7.3

Note: WPI(AC)= Wholesale Price Index (All commodities)
 WPI(MP) = Wholesale Price Index (Manufactured Products)
 CPI(IW) = Consumer Price Index (Industrial Workers)

Source: Acharya 2002a

Even then, poverty is a more complex story. The National Sample Surveys (NSS) are compiled on a quinquennial basis interspersed with annual surveys using ‘thinner’ samples. These annual surveys revealed that the poverty headcount ratio (HCR) increased in the wake of the 1991 crisis: 34.3 (1989-90), 35.5 (1990-91), 39.4 (1991-92), 40.7 (1992-93).⁶¹ But according to adjusted estimates from the last three quinquennial surveys poverty declined in India in the 1990s (table 5).⁶² Note that compared to the official estimates of accelerated poverty reduction post-1993, in the adjusted estimates the drop in poverty is more evenly spread since 1987. But the rural-urban poverty gap increased. While overall growth had picked up, agricultural growth (which has a strong impact on poverty reduction in India) lagged at only 3.2 percent during 1993-2000.⁶³ Finally, the rise in inequality affected the reduction in poverty. If all households had equally experienced the growth rate in average per capita consumption expenditure (10.9 percent from 1993-94 to 1999-2000), the all India HCR would have been 21.4 percent in 2000 compared to the actual value of 22.7 percent.⁶⁴

TABLE 5: Declining Poverty in India

	1987-88		1993-94		1999-2000	
	<i>HCR</i>	<i>Poverty-</i>	<i>HCR</i>	<i>Poverty-</i>	<i>HCR</i>	<i>Poverty-</i>
	<i>(percent)</i>	<i>Gap</i>	<i>(percent)</i>	<i>Gap</i>	<i>(percent)</i>	<i>Gap</i>
<i>Rural</i>						
Official estimates	39.4	9.4	37.1	8.4	26.8	5.2
Adjusted estimates	39.4	9.4	33.0	7.0	26.3	5.2
<i>Urban</i>						
Official estimates	39.1	10.4	32.9	8.3	24.1	5.2
Adjusted estimates	22.5	4.8	17.8	3.7	12.0	2.3
Ratio of rural-urban adjusted HCR	1.75		1.85		2.19	

Note: Official estimates were adjusted for changes in questionnaire design and revisions in the poverty lines. HCR = Headcount Ratio

Source: Deaton and Dreze 2002.

Critics also argue that economic reform compromised on public investment and poverty reduction programmes. An alternative fiscal correction measure might have involved greater reliance on revenue increases through higher direct taxes on the rich, which would have released public funds to protect the poor in the years immediately after the crisis. Table 6 shows that the social sector expenditure by the centre and states as a percentage of aggregate public expenditure declined slightly in the first half of the 1990s but rose after 1994-95. Per capita expenditure steadily increased after dipping in the immediate post-1991 period. It is noteworthy, however, that as a percentage of GDP social expenditure did not increase over the 1990s.

TABLE 6: Social Sector Expenditure by Centre and States

	As percent of GDP	As percent of aggregate public expenditure	Per Capita expenditure (in Rs.) in 1993-94 prices
1987-88	7.74	25.29	562
1988-89	7.4	25.22	583
1989-90	7.64	25.19	633
1990-91	6.78	24.85	623
1991-92	6.58	24.28	599
1992-93	6.39	24.06	594
1993-94	6.46	24.58	623
1994-95	6.41	25.01	633
1995-96	6.4	25.95	675
1996-97	6.48	27.22	739
1997-98	6.6	26.95	789
1998-99	6.94	27.36	890
1999-2000	7.55	27.69	1027

Source: Dev and Mooij 2002.

The impact on inflation and poverty confirms the apprehensions Singh had about the rigidities in the Indian economy. Sharp fiscal contraction could not be sustained for long. This also partly explains the eventual increase in subsidies and rising fiscal deficit from 1993 onwards.

Conclusions

Several lessons emerge from India's experience of financial crises and carefully managed engagement with the IMF and external sector.

India's ownership of policy was very important. Despite criticisms of bowing to external pressure, the government's unilateral announcement of economic reforms was its strongest defence. Even so, it is a mistake to attribute reforms only to a technocrat-driven offensive. Technocrats had been in government since the mid-1980s but had failed to introduce reform. The crisis provided the opportunity. Yes, the reform measures favoured certain sections in the government more than others. But in the situation that India was in, negotiating a standby agreement would have been much harder without broader reforms in the pipeline.

The question is whether ownership can also be a hindrance to reform. Outside of an immediate crisis situation a government might actually have lesser bargaining power vis-à-vis the IMF when seeking more loans (see Miller's paper in this study). This is arguably why Indian policymakers also decided not to continue with the standby agreement. While that was an example of 'national strength' and ownership, it also hindered efforts to control deficits, which now stand at a precariously high level.

A related question is what should be the scope of the IMF's involvement? Potentially, the IMF could not only provide *cash* (as lender-of-last-resort), but also help increase the technical *capacity* of policymakers to deal with financial crises and even help *coordinate* the efforts of various ministries towards this end. India relied on IMF funds and its policymakers also benefited from close interactions with IMF staff to exchange notes on policy alternatives. But do such strategies always increase the *credibility* of reform efforts? Gaps in IMF capacity can itself undermine coordination with the client and credibility of reform (see the Indonesian case in this study).

A related third question that arises is whether policymaking by technocrats increases the probability of the success of reforms. The Indian experience clearly highlights how some decisions were of a more technical nature while others explicitly threatened particular interests. Many of the measures undertaken as a response to external vulnerability – exchange rate regime, external liberalisation, capital market liberalisation – did not significantly affect any of the older interests that informed India's political economy in the pre-1991 period. But a democratic process was also essential. Democratic opposition helped direct policymakers' attention to inflation, poverty and social sector spending. These problems were not wholly addressed but the

adverse impact of crisis and reform remained limited, relative to other countries in this study. Many policy measures were criticised in the 1990s, but reforms were never discredited.

Finally, a larger question is whether structural reforms can really be separated from emergency measures to deal with financial crises. Structural reforms in India – trade policy, industrial policy and privatisation – involved several competing interests that have not been discussed in this paper. Demands for capital account liberalisation also stem from sections seeking to attract FDI into manufacturing industries. Recovery of loans by the banking sector cannot ignore the impact on rural areas, agricultural investment or reform of procurement and distribution policies. Large capital inflows build up foreign exchange reserves but also have impact on nascent export-oriented industries or on inflation in the wider economy. These have been the more contentious issues in India's reform experience.

Ultimately, a fortuitous combination of factors and circumstances helped India weather both crises: strong growth rates in a diversifying economy, absence of large amounts of private dollar-denominated debt that shielded the private sector, changing political alliances within the country that ensured a minority government was not pulled down, a like-minded technocracy that ensured continuity and consistency of policies for a long period of time, and a shift in the relationship with external actors that allowed substance to supersede rhetoric. Note, however, that in both cases crises created the conditions for reform: in 1991 emergency steps became feasible; in 1997-98 capital controls gained renewed importance. Some original signs of vulnerability still remain even as a growing economy demands closer integration with the rest of the world. Future developments will continue to test the balance of institutional and political power of new and old interests.

Endnotes

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- ⁴ Rangarajan, C. (1991b). "Recent Exchange Rate Adjustments: Causes and Consequences." *Reserve Bank of India Bulletin* 45(9): 905-909, p. 906.
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- ⁶ Joshi and Little (1994) *Op. Cit.*, p. 162.
- ⁷ See detailed discussion in Towe, C. (2001). "India and the Asia Crisis." In: T. Callen, P. Reynolds and C. Towe (eds.) *India at the Crossroads: Sustaining Growth and Reducing Poverty*. Washington, D.C.: IMF and Acharya, S. (2002b). "Managing India's External Economic Challenges in the 1990s." In M. S. Ahluwalia, Y.V. Reddy and S.S. Tarapore (eds.) *Macroeconomics and Monetary Policy: Issues for a Reforming Economy*. New Delhi: Oxford University Press.
- ⁸ Towe (2001), *Ibid.*, p. 13.
- ⁹ Bhaduri, A. and Nayyar, D. (1996). *The Intelligent Person's Guide to Liberalization*. New Delhi: Penguin, p. 29.
- ¹⁰ Interview, Manmohan Singh, *Indian Express*, 17 February 2003. The President did not have a veto over government policy but his advice carried the influence of his office. Furthermore, he belonged to the same party as the government's.
- ¹¹ Interview, Manmohan Singh, New Delhi, 27 June 2003.
- ¹² RBI (Reserve Bank of India). 1991. *Annual Report 1990-91*. Mumbai, p. 126.
- ¹³ Corbridge, S. and Harriss, J. (2000). *Reinventing India: Liberalization, Hindu Nationalism and Popular Democracy*. Cambridge: Polity Press, p. 162.
- ¹⁴ Singh had immense faith in Rangarajan and their close coordination helped policy continuity.
- ¹⁵ Cited in Nayar 1998, *Op. Cit.*, p. 340.
- ¹⁶ Budget speech to the *Lok Sabha*, 4 March 1991.

- ¹⁷ Manmohan Singh, Budget Speech to the *Lok Sabha*, 24 July 1991.
- ¹⁸ RBI 1991, *Op. Cit.*, p. 136.
- ¹⁹ I thank Shankar Acharya for this insight.
- ²⁰ Phone interview with former Finance Ministry negotiator, 3 May 2004.
- ²¹ Manmohan Singh, Budget speech to the *Lok Sabha*, 29 February 1992.
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- ²³ Varshney (1999), *Ibid.*, p. 247 (emphasis original).
- ²⁴ Phone interview, Montek Ahluwalia, 27 April 2004.
- ²⁵ Calculated from GOI 1997, Annexure 4.
- ²⁶ See Acharya (2002a), *Op. Cit.* for a discussion on factors influencing the deficit.
- ²⁷ Phone interview, Arvind Virmani, 8 May 2004.
- ²⁸ Reddy, Y. V. (1997b). “Exchange Rate Management: Dilemmas.” *Reserve Bank of India Bulletin* 51(9): 701-708.
- ²⁹ Interview, Manmohan Singh, in Balasubramanyam, V. N. 2001. *Conversations with Indian Economists*. New Delhi: Macmillan, p. 94. Also see C. Rangarajan’s (RBI Governor 1992-97) interview in the same volume.
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- ³¹ For details on the case, see Acharya (2002b), *Op. Cit.*, p. 221-222.
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- ³³ Later the IMF’s India Division staff endorsed the strategy. The IMF also helped provide information on other countries’ experiences in dealing with capital inflows. Phone interview, Arvind Virmani, 8 May 2004.
- ³⁴ It also explains why Joshi, V. (2003). “India and the Impossible Trinity.” *World Economy* 26(4): 555-583 labels India as having an “intermediate regime with capital controls”, as opposed to what the government called ‘market-determined’ rate or the IMF characterised as ‘independently floating’ rate.

³⁵ Ahluwalia, M. 2002. "India's Vulnerability to External Crises: An Assessment." In M. S. Ahluwalia, Y.V. Reddy and S.S. Tarapore (eds.) *Macroeconomics and Monetary Policy: Issues for a Reforming Economy*. New Delhi: Oxford University Press, p. 210.

³⁶ A new institution – the Foreign Investment Promotion Board (FIPB) – was created with the Principal Secretary to the Prime Minister as chair to expedite approvals for FDI proposals.

³⁷ It also recommended a shift away from debt to non-debt-creating flows, regulation of external commercial borrowings, discouraging volatile flows from NRIs and gradual liberalisation of outflows. For a discussion, see Reddy, Y. V. (1998). "Managing Capital Flows." Lecture at the Asia-Pacific Research Center, Stanford University, 23 November. Reprinted in Y.V. Reddy, *Monetary and Financial Sector Reforms in India: A Central Banker's Perspective*, New Delhi, UBSPD, 2000. The improved foreign exchange position was a key motivating factor.

³⁸ Nayyar, D. (2002). "Capital Controls and the World Financial Authority: What Can We Learn from the Indian Experience?" In: J. Eatwell and L. Taylor (eds.) *International Capital Markets: Systems in Transition*. New York: Oxford University Press, p. 101. Nayyar cites the example of Latin American countries where dollarised systems meant that the central bank's foreign exchange reserves limited its ability to act as a lender of last resort when speculation against the national currency led to conversion into dollars.

³⁹ IMF(International Monetary Fund) (1997). "Press Information Notice: IMF Concludes Article IV Consultation with India." [<http://www.imf.org/external/np/sec/pn/1997/pn9711.htm>]. Accessed March 2004.

⁴⁰ Interview, Manmohan Singh, New Delhi, 27 June 2003.

⁴¹ RBI (1997), *Op. Cit.*, p. 19.

⁴² Interview, C. Rangarajan, in Balasubramaniam (2001), *Op. Cit.*, p. 111.

⁴³ Even in the pre-1991 period the government had sought NRI deposits by offering high interest rates, exchange guarantees and tax benefits. See Karl Habermeier's discussion in Ariyoshi et al. 2000, 84. Of late, NRIs have also interacted with the stock market regulator to develop policies for venture capital funds (see Virmani (2004), *Op. Cit.*, p. 61).

⁴⁴ *The Economist* (1997). "Indian test match." 14 August.

⁴⁵ Acharya (2002b), *Op. Cit.*, p. 238.

⁴⁶ Nayyar (2002), *Op. Cit.*, p. 117.

⁴⁷ Discussion based on Ahluwalia (2002), *Op. Cit.* and Nayyar (2002), *Op. Cit.*

⁴⁸ Jadhav, N. (2003). "Capital Account Liberalisation: The Indian Experience." Paper presented at Conference on 'A Tale of Two Giants: India's and China's Experience with Reform and Growth', International Monetary Fund and National Council of Applied Economic Research, 16 November, New Delhi. [www.imf.org/external/np/apd/seminars/2003/newdelhi/jadhav.pdf]. Accessed March 2004, p. 29; Kohli, R. (2001). "Capital Flows and Their Macroeconomic Effects in India." IMF Working Paper 01/192. [<http://www.imf.org/external/pubs/cat/longres.cfm?sk=15471.0>]. Accessed March 2004, P. 17.

⁴⁹ See RBI 1992, 24-26 for recommendations.

⁵⁰ Ahluwalia 2002, 199-200.

⁵¹ GOI 1993b, 13.

⁵² Ahluwalia 2002, 198.

⁵³ GOI 1993b, 32.

⁵⁴ For an excellent discussion of the political economy of capital markets reform, see Shah and Thomas 2001.

⁵⁵ Ahluwalia (2002), *Op. Cit.*, p. 199-200.

⁵⁶ GOI (Government of India) (1993b). "Public Sector Commercial Banks and Financial Sector Reform: Rebuilding for a Better Future." Ministry of Finance Discussion Paper, New Delhi, p. 13.

⁵⁷ GOI (1993b). *Op. Cit.*, p. 32.

⁵⁸ For an excellent discussion of the political economy of capital markets reform, see Shah, A. and Thomas, S. (2002). "The evolution of the securities markets in India in the 1990s." Indian Council for Research on International Economic Relations Working Paper No. 121. [<http://www.icrier.res.in/publications.html>]. Accessed May 2004.

⁵⁹ Acharya (2002a), *Op. Cit.* has a more refined explanation of the inflation dynamics than has been presented here.

⁶⁰ Nayyar, D. (1996). *Economic Liberalization in India: Analytics, Experience and Lessons*. Calcutta: Centre for Studies in Social Sciences, p. 23.

⁶¹ Nayyar (1996), *Ibid.*, p. 33.

⁶² Deaton, A. and Dreze, J. (2002). "Poverty and Inequality in India: A Re-examination." *Economic and Political Weekly* September 7: 3729-3747.

⁶³ See also Datt, G. and Ravallion, M. “Is India’s Economic Growth Leaving the Poor Behind?” *Journal of Economic Perspectives* 16(3): 89-108 on unequal growth across states.

⁶⁴ Deaton and Dreze (2002), *Op. Cit.*, p. 3739.

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