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Adjustment in Uncertain Times

The period 1967–68 to 1980–81 was one of the most unstable and unpredictable ones in the economic history of India. Both on the national and international planes, India was called upon to grapple with events and developments such as the Bangladesh war, breakdown of the Bretton Woods system, the dawn of the regime of floating rates, two oil shocks, the Emergency and the imperatives of development of the domestic economy. This chapter seeks to bring out the conscious application and evolution of policy measures by the Reserve Bank and the government to restore balance and adjustment in the external sector, and the relationship between the Bank and the Finance Ministry in addressing these issues.

POST-RUPEE DEVALUATION ADJUSTMENT PANGS

It may be recalled that while the Third Plan was in progress, certain events imposed unforeseen pressures and burden on the Indian economy. The sharp increase in defence expenditures consequent upon the armed conflict with China in 1962, and with Pakistan in 1965 and again in 1971, and the levelling off of foreign aid, placed the economy in a serious bind. Two consecutive droughts in 1965–66 and 1966–67 aggravated the situation further to reach crisis proportions. In both these years, the GDP fell in absolute terms. Despite tight controls on imports (through quantitative restrictions) and severely restrictive foreign exchange regulations, the current account deficit was 1.8 per cent of GDP. Foreign exchange reserves were low, at Rs 47.4 crore, less than necessary to cover three months' imports. An overwhelming proportion of the current account deficit was financed through inflows of concessional external assistance.

The impact of these adverse circumstances brought into full view the weaknesses of the economic strategy that had been followed in the preceding years. One of these was the intersectoral imbalance between agriculture and industry, and the other, ignoring the option of foreign trade as a stimulant to economic growth, which stemmed from the highly pessimistic view taken by India's policy-makers on the potential of export earnings, despite Dr Manmohan Singh's seminal research that strikingly refuted the export pessimism.[1] As C. Rangarajan, an economist himself, who later became Governor of the Reserve Bank, rightly stressed, 'policy-makers underestimated not only the export possibility but also the import intensity of the substitution process itself'.

The relative neglect of agriculture was, among others, a result of the availability of large quantities of foodgrains in the late 1950s and early 1960s under the PL480 programme. This was, however, corrected later through the adoption of high-yielding crop technology and breakthroughs in research in plant genetics, combined with increased investment in irrigation and an incentive-based farm support pricing policy. This was a major policy shift that helped to reduce the foreign exchange outgo on foodgrain imports.

Another development with serious consequences for the economy was the abrupt reduction of external assistance. The main casualty in the adjustment to reduced levels of foreign assistance was growth, as economizing on essential imports necessarily entailed reduction in aggregate and sectoral growth targets. Other discernible shifts in policy related to a greater effort at export promotion, a greater role for price incentives and a shift to quick high-yielding projects with shorter gestation periods.

The fall-out of the uncertain external aid scenario put on hold the longer-term planning exercise. But the general direction of policy was towards strengthening the process of liberalization. The June 1966 decision to devalue the rupee was not only to correct the overvaluation of the rupee but to move towards a more liberalized trade regime. Around this decision was also woven the aid package that was expected to underwrite the aid programme. As mentioned earlier, the devaluation of the rupee in 1966 had a remarkably unfavourable political reception. The government failed to elicit significant support. The behaviour of key indicators was not supportive of the policy change either, for, devaluation failed to push up export earnings or enhance the level of foreign aid as expected. The export earnings the year following devaluation (1967) declined by 8 per cent. Nor did the aid package materialize. S. Boothalingam, Secretary in the Ministry of

[1] Manmohan Singh, *India's Export Trends*, Clarendon Press, Oxford, 1964. Singh, much later, in the 1990s became India's Finance Minister and prime architect of the successful reform programme.

Finance at the time when the decision was taken, later concluded that devaluation 'was not allowed to work'. It failed to stimulate a major shift into export production as it coincided with two successive serious droughts which necessitated massive food imports and induced a sharp recession.

The policy issue that came to the fore was: could the decision to devalue have been avoided? A Finance Ministry note to Members of Parliament explained why the decision had to be taken. The note clearly stated:

> The action could not be postponed as all further aid negotiations hinged on it. It is extremely doubtful whether, without demonstrable evidence of our determination to push up our exports and improve the internal viability of our economy, we shall continue to get external credits, particularly, as we are already at the stage when we have to incur fresh debts in order to pay off old ones. Without reasonable prospects of aid forthcoming on the scale contemplated by us, the finalization of the Fourth Plan will be still further postponed.

Evidently, the mood of the donors had changed. It was no longer that of the early 1960s, when they had endorsed the general framework of the Third Plan and made a declaration of intent to provide assistance on soft terms.

In the months following the devaluation, RBI Governor Bhattacharyya paid attention to the debate while closely monitoring the evolving foreign exchange situation. On 9 February 1967, in a top-secret note, the governor alerted the Finance Minister that even with the resumption of normal consortium aid, the country would run into balance of payments difficulties as a result of the previous year's drought and the growing burden of debt repayments. Based on the revised estimates prepared by the Reserve Bank's balance of payments division, which indicated a level of foreign exchange reserves of Rs 282.1 crore ($376 million) as on 27 January 1967, Bhattacharya clearly warned that if timely corrective action was not taken, the reserves would breach the legal minimum even before the new government assumed office. The disconcerting fact was that, despite a drawing of $187.5 million from the International Monetary Fund (IMF) and a substantially higher level of non-project aid, the foreign exchange situation had shown no tangible signs of improvement. The Governor attributed this to a variety of reasons: aid was not available for a large part of the requirements such as oil and defence; India had to import from non-aid-giving countries while aid-giving countries insisted that aid should result in higher purchases and not in substitution of purchases normally made with free foreign exchange.

Recognizing that the response on the rephasing of debt had been extremely poor and the World Bank initiative had met with little success, the RBI Governor lamented that this, together with the fall in export earnings, would place additional strain on the reserves. Drought for a second year in succession would further compound the problem by adversely affecting the exports of agricultural commodities and pushing up import payments on food. Superimposed on the enlarged trade deficit were the sizeable payments on external debt. In this bleak scenario, a further drawal on reserves was inevitable. The Reserve Bank's estimate was February to July 1967 would see the reserves drop at a monthly rate of Rs 36 crore or $48 million, reducing them to a rock-bottom level of Rs 80 crore or $106 million by end-July 1967. Predicting a critical external payments situation very soon after the new government took office, Bhattacharyya underlined the need for remedial measures if the government was not to be caught off-guard. It was a question of timing and, here, the two most important considerations were to act early and to act when 'things have been worse and look like getting better'.

The remedial measures suggested were as follows. Commitments for imports against free foreign exchange should be kept to the absolute minimum and, if possible, avoided, till the new government had had the time to examine the foreign exchange situation in detail. All further imports must be covered by the aid available and the announcement of the new import policy for the period April–September 1967 should be deferred till the new government had had the time to assess the position. A comprehensive review of export promotion measures was recommended, including an examination of the programme of subsidies to see if changes were warranted. As an addendum, two other options were indicated, viz. approaching the IMF and the consortium for a standstill arrangement on debt obligations. However, with indebtedness to the IMF at $425 million, the Governor cautioned the Finance Minister that the Fund management may find it difficult to support another large drawing in April 1967 without specific undertakings, not only to impose fiscal and monetary discipline, but also to continue liberalization of imports and avoid intricate and extensive systems of export incentives. In the Governor's reckoning, the need for a Fund drawing was 'urgent' and 'inescapable'. Knowing that it would be politically difficult for any new government to give undertakings that entailed tightrope walking, the Governor's idea was to activate thinking among senior treasury officials on the options available to contain a prospective deterioration in the external payments situation, including vigorous pursuit of the standstill agreement on debt repayments.

The above recommendations constituted good practical advice. But what if approaches to the IMF and the World Bank failed to materialize? Fearing the possibility of such an outcome, a fall-back option was mooted. In a supplement attached to the main note, the Governor prefaced his opening remarks in brackets to read:

> It is suggested FM may not touch on this point tomorrow unless it comes up. Our idea is that we shall separately prepare a note on this with necessary legislative change to be approved after the elections, but by early March. FM, however, should indicate whether we should go ahead on this basis at this stage.

Knowing that for a variety of reasons, particularly relating to the convenience of the new government, it might be thought desirable to postpone a formal approach to the IMF till June or July, and if the standstill arrangement on debt payments too was not forthcoming, the RBI Governor saw real danger of the reserves piercing the legal minimum requirement by the end of May. A tactical way of buying time was to change the legal requirement, which at that time was Rs 200 crore, of which Rs 115 crore had to be in the form of gold valued at the old parity for the Indian rupee. Amendment to the RBI Act would entail stating that the gold parity for this purpose would be the parity after devaluation, which would automatically increase the value of gold holdings from the then existing level of Rs 116 crore to approximately Rs 181 crore, releasing Rs 65 crore more of foreign exchange reserves and thus preventing a fall in reserves below the legal minimum of Rs 200 crore. As an astute banker, Governor Bhattacharyya was aware that such an amendment could weaken public confidence but he was prepared to counteract such sentiments by stating that it was anomalous that the Bank should continue to value its gold holdings at the pre-devaluation rate. He advised the government that if such a change was contemplated, it should be undertaken as soon as possible and preferably before the coming session of Parliament, for a change of this nature had to be made from a position of strength and not when the reserve level was precariously close to the minimum.

On receipt of the governor's secret communication and realizing that a critical foreign exchange situation was likely to develop in the coming months, the Finance Minister immediately convened a meeting of Economic Ministers, which was presided over by the Prime Minister. A wide-ranging discussion ensued based on the issues raised in the RBI Governor's note and the additional note on the foreign exchange situation prepared by the Finance Ministry. It was decided to authorize B.K. Nehru, then India's Ambassador to the US, to informally sound out the Managing Director of the IMF, Schweitzer, on a possible drawing by India, based on a brief the Finance Minister instructed I.G. Patel to prepare in consultation with Bhattacharyya and Jagannathan. Nehru was also to call on Woods, President of the World Bank, to discuss the question of debt relief. In Delhi's perception, wrapping up the debt relief issue was more urgent than a Fund drawing. Keen that the approach to the Fund should in no way jeopardize the standstill arrangement on debt payments that India was seeking from the World Bank, Jagannathan, in his communication to Ambassador Nehru, stressed that Delhi regarded the standstill on debt as the 'real answer' to India's problems. The government's anxiety was that discussions with the IMF should not lead the World Bank to minimize the urgency of the debt relief operation. Knowing that IMF and World Bank matters were seldom kept in separate compartments, after alerting Nehru on the sensitivities of the Bretton Woods twins, the matter was tactfully left in his able hands to handle in the best way possible.

The purpose of deputing Nehru as an emissary of the government to Schweitzer was to prepare the ground to soften the attitude of the IMF towards a drawing by India. Nehru, in his inimitable way, gently reminded Schweitzer of his earlier assurance that once the decision on a realistic exchange rate was adopted and liberalization of imports undertaken, additional assistance from the IMF would be forthcoming. That postdated cheque was now coming up for encashment. With clarity and intellectual coherence, Nehru emphasized that in the current recessionary scenario and drought-induced upward pressure on the prices of basic consumer goods, excessive regard for financial discipline could become an enemy of the industrial revival that was so necessary if the success of liberalization was to be demonstrated. He hinted that if the new government could not agree on terms with the IMF, the liberalization policies, in which the Fund had a wider stake, would be jeopardized. In short, he urged the Fund to desist from enforcing further conditionalities, thereby avoiding a 'sterile impasse'.

At the World Bank end, Woods was pushing the Bank's Board to participate in a debt relief exercise. Recognizing that India was not in danger of defaulting on its debt but the debt service absorbed nearly 14 per cent of the country's export earnings, and that the critical need was for free foreign exchange to maintain the development momentum, Woods plugged hard for arrangements that would ease the debt service burden. While discussions with the members of the India consortium proceeded, Woods thought of an innovative initiative to induce India's official creditors to grant debt relief. He decided that the World Bank, as one of India's major creditors, should set an example by placing up to $50 million from India's debt servicing payments for 1967–68 on deposit with the Reserve Bank of India. Subsequently, the World Bank participated in the debt relief agreement negotiated with the consortium members for the four-year period starting 1 April 1967 to an amount of $15 million per year. Although the amount involved was small, its significance was that it was the only case where the World Bank participated with other official creditors in general debt relief. Both these initiatives proved controversial and a number of Executive Directors questioned the legality of the deposit scheme, as also the wisdom of being involved in debt relief.[2]

From India's viewpoint, the response from the consortium was not such as would obviate the need for a drawing from the IMF in 1967–68. Although Woods persisted, visible progress was not evident on debt financing. There were, however, indications of a marked improvement in export earnings during February and March 1967, due largely to temporary factors such as speeding up of export receipts and inflow of banking funds. Although non-project assistance of $900 million had been agreed to in principle, there was considerable delay in translating this assistance into loan agreements. Unwillingness to supply commodities like sulphur or aircraft spares, needed against aid, refusal to pick up payments against past orders, and the need to import goods that were either not eligible for aid finance or had to be obtained from non-aid sources of supply, all resulted in a larger than anticipated outgo of free foreign exchange. The result was, while aid-financed imports were lower, imports on government account financed out of free foreign exchange resources were higher.

With aid disbursements remaining sluggish and the drought contributing to a worsening of the trade position, it was no surprise that Indian officials apprehended a serious external crisis. There were some in the official hierarchy who pushed for tightening import controls and halting the liberalization process. In February 1967, India's reserves suffered an appreciable drop in dollar terms. A rapid worsening of the external accounts position was anticipated after April, when the lean export season would begin and heavy debt repayments become due on the substantial IMF maturities. A provisional moratorium on debt repayments from Woods and softer conditionality prescriptions from Schweitzer were seen as the only way to ride out of the crisis.

The months from March to December 1967 saw intense and continuous consultations with the Bretton Woods twins. There were four full-

[2] Statement by Woods on India's debt servicing problem at the meeting of Executive Directors, 11 and 20 July 1967.

fledged IMF missions between December 1966 and November 1967, including a special mission on behalf of the management and the compensatory financing team. Indian officials, too, had talks with the management on a number of occasions. In February 1967, B.K. Madan, then Deputy Governor of the Reserve Bank and Vice Chairman of the Industrial Development Bank of India (IDBI), succeeded Anjaria as India's Executive Director at the IMF. During his tenure there, he skilfully orchestrated the request for compensatory finance drawing (CFF) of US$90 million, which came before the Board for approval on 22 December 1967, and postponement of the repurchase of US$387.5 million. The request for postponement of the repurchase obligation, scheduled on the same day's agenda, however, had to be deferred to 29 December 1967, as several Directors needed time to consider some aspects of it.

Leafing through the Board minutes of the meeting of 22 December 1967, it is evident that India's first drawing on the special facility, intended to compensate for the shortfall in exports resulting from the drought, evoked a positive response. The debate, though friendly, was not free of critical overtones, however. The unprecedented duration, range and intensity of the drought and its all-pervasive and far-reaching effects on every sector of the economy, so vividly portrayed by Madan in his opening statement, was followed by expressions of deep concern by the Board. The emphasis on agriculture and the package approach adopted by the Indian government were seen as a step in the right direction; likewise, the disaggregation of financial planning and greater flexibility in targeting in the new Plan strategy were viewed as correct policy responses deserving unqualified support. But the need for stricter control of money supply was emphasized and caution was urged in pursuing selective credit relaxation.

The main issue at stake was adequate flow of foreign aid, on which rested the post-devaluation liberalization policy. It was a hard-fought issue. Madan, in his opening remarks, made the compelling observation:

> There is no tenable approach consistent with a satisfactory rate of growth which, at the present stage of the country's development, can do without significant external infusion or supplementation of resources in a reasonably freely disposable form. A decisive improvement in the aid outlook thus remains a major desideratum in the international outlook for growth.

The draft decision on the India–Article XIV Consultation report, too, had underscored the need for adequate flow of foreign assistance and the need to remove the 'haziness' surrounding the expected size of aid.

Although recognized by all, the aid issue continued to elude the donor group, particularly the USA.[3] As for India's request for a drawing of US$90 million under the decision on compensatory financing of export fluctuations, since it met the requirements, it received the seal of approval from the Fund's Board.

The rescheduling of the repurchase obligation of $387.5 million came up for consideration by the Board on 29 December 1967. There was considerable uneasiness and behind-the-scene discussions with regard to the blurring of the distinction between the repurchase under the stand-by of March 1965 and repurchase of the special drought drawing of April 1966, and the implications of such a procedure on Fund policy. While there was no difficulty in supporting the former, stiff opposition was encountered from Directors representing some European Economic Community (EEC) countries to the latter. The failure of the IMF management to anticipate any objection to the routine treatment of a special drawing and the absence of any special explanation in the staff papers for amalgamating the repurchase for the two different drawings of 1965 and 1966 were regarded as a serious procedural lapse on the part of the management by the EEC Directors. In their understanding, the short maturity of the 1966 drawing reflected the special circumstances associated with a drought, which they had believed, was temporary. Their concern centred on the insufficient conditionality governing the use of Fund resources and apprehension that postponement would convert the special drawing into an ordinary one. Moreover, in their perception, the Indian stabilization effort lacked teeth; they pressed that the request for repurchase should be contingent upon an appropriate framework of policies.

Despite the opposition within the Board, the management stood steadfastly behind the proposal and saw it through by affirming the exceptional nature of the April 1966 drought-related transaction, and by reiterating its intention to take full advantage of the offer of continuous contact and consultation with India. The unswerving support of the management was enough to convince the remaining members of the Board on the genuineness of the need to support the request. They recognized that it would be

[3] The US Director took shelter behind the explanation that 'it had not yet been feasible for the US to make a full pledge in the current fiscal year, largely because of the long delay and deep cuts in the Aid bill'; and added that because of the deep cut in appropriation it appeared likely that the US pledge would be in the neighbourhood of only two-thirds or three-fourths the size of the previous year's pledge, which, in turn, had been somewhat looser than the standard pledge that had been made in the early 1960s.

inconsistent to reject the proposed decision, particularly since the Board felt that the policies were generally in the right direction as per the earlier week's discussion. They emphasized that the past record of cooperation and responsible policies merited unqualified support. The management's intervention helped eight Directors in a row to lend support to the request, buttressed by the political argument of India's world stature and image, the moral argument of everyone being a shareholder in the fate of India, and the procedural and practical argument that India had programmes that were, in fact, approved by the IMF as it had complied with all the Fund's stipulations. In the circumstances, the Directors who had procedural qualms were willing to overlook them and give India the benefit of doubt by accepting the proposed decision without dissent. The extra week, in the event, proved useful.

In retrospect, what emerges from the India–IMF dialogue of the late 1960s is that the Fund, while supportive of India's funding needs, also made serious efforts to gain a toe-hold of influence on the performance of the Indian economy. The aspects of performance at issue were balance of payments policies, controls over imports, monetary policy, particularly interest rates, and the relative emphasis on agricultural output. Poor performance in these areas, it was felt, not only handicapped growth but seriously endangered creditworthiness for future borrowing.

In the meanwhile, realizing that the balance of payments position displayed no clear signs of improvement in exports, the new RBI Governor, L.K. Jha, who had taken over the reigns from Bhattacharyya, in his first credit policy announcement, sought to selectively liberalize credit facilities for exports. Apprising the Reserve Bank's Central Board of Directors of the background to the selective liberalization, the Governor stated that it was confined to exports of the domestic engineering and small industry sectors, and clarified that the new policy was primarily aimed at lowering the rate of refinance in respect of certain sectors. He assured the Board that the RBI would take a view on modifying the system pertaining to liquidity ratios after a clearer picture emerged of the crop out-turn, credit demand and the Bank's resources position in the coming busy season.

Welcoming the selective liberalization, the Central Board wanted to know whether the scope of the 4.5 per cent rate could not be extended to cover all post-shipment bills, and also whether traditional exports should not get the same facility. The Governor explained that if the 4.5 per cent preferential rate was to be extended to all export bills, it would have the effect of delaying the repatriation of export receipts. Likewise, an extension to cover preshipment finance in connection with traditional exports might entail very large sums, as also pose problems of distinguishing between exports of preshipment finance and domestic credit needs. This meant that, under the Bank's package of new measures, the preferential rate of 4.5 per cent would be available for packing credit advances to exporters of only engineering and metallurgical products. For all other packing credit and post-shipment export bills in all currencies, refinance would be charged at the Bank rate. Simultaneously, ceilings of 6 per cent in respect of exporters of engineering and metallurgical products, and 8 per cent in the case of other packing and post-shipment advances were prescribed as rates to be charged by banks to the ultimate borrower.

Jha also took the Central Board into confidence on the prospective reduction of external aid. He said that it was not a dramatic new development but something that had been building up over a number of months. The underlying presumption of the Woods–Mehta accord of 1966 was phased decontrol of imports, supported by continued long-term support for the liberalization programme. Woods himself had corroborated the Indian stand by emphasizing that the steps India was contemplating required substantial additional non-project commitments in an immediately usable form, with an assurance of such assistance in subsequent years. In fact, Woods volunteered to approach the consortium members to explain India's funding for the liberalization programme. In the follow-on talks that ensued between Woods and UK officials, he not only referred to funding for one year, but also pointed out that the same problem would arise in the second and third years also.

The significant development was that the liberal environment for foreign assistance of the 1950s and early 1960s had been vitiated. The consensus that had brought together those motivated by security concerns and those motivated by humanitarianism and a belief in the United States' interest in a rapidly expanding world economy, had disappeared.[4] It was this consensus and support that was eroded in the mid-sixties. Thus the proposal for replenishment of IDA ran into difficulties in the US Congress.

Following the annual IMF-World Bank meeting in October 1967, some broad indications became available on India's debt relief rescheduling problem. Reporting the trend of the discussions, Jha apprised the Central Board that the US response to the IBRD president's plea was good, the UK's slightly less so and the European attitude was lukewarm. This last attitude was

[4] Robert J. Berg and David F. Gordon, 'Cooperation for International Development: The United States and the Third World in the 1990s'.

related to Europe's, particularly France's, interest in Africa, whereas, as was well known, IDA's activities were heavily slanted towards South Asia—with India as the largest beneficiary. Governor Jha also indicated that the World Bank had come to the conclusion that its terms of lending were too onerous for a country like India and hence all lending to India should come from the Bank's soft loan window—IDA. But India was already the recipient of a fairly large share of IDA money. This created a lobby in America pressurizing for a slowdown of the share going to India at a time when IDA itself was running out of funds and failing to obtain adequate replenishment of resources. The failure to obtain adequate funding was linked to a host of internal political factors in the US, viz. its commitment to reduce the outflow of dollars, resisting inflation and maintaining the integrity of the US, dollar by preventing a dollar devaluation. In mid-1967, it was highly uncertain whether IDA could get adequate funds and, if so, when?

With the replenishment of IDA running into difficulties in the US Congress, the connection between aid and liberalization placed India in a peculiar quandary—its import liberalization was based on IDA bank-rolling, which did not materialize. In the Indian authorities' thinking, one way of overcoming the impasse was to activate the promised contribution from countries other than the US. The other solution was for the World Bank itself to take a second look at its lending policy and consider providing loans on soft terms. During his several trips abroad, Jha made it a point to meet officials of several European countries to discuss the issue and pave the way for a more dependable flow of aid.

On 1 April 1968, Robert McNamara succeeded Woods as President of the World Bank. Considered a champion of the developing world, McNamara, on assuming office, made it known that India would continue to obtain the largest slice of assistance from the World Bank group. He was convinced that the developing countries needed more assistance and he made it his mission to find ways to provide it. In order to be able to offer insights and solutions, McNamara travelled extensively; within six months of assuming office he scheduled a visit to India for an on-the-spot assessment. It is reported that L.K. Jha and I.G. Patel were two bureaucrats whose advice he sought freely.

India's import policy was predicated on continued external assistance. The Reserve Bank judged that the reduced foreign assistance would impact on both the reserves and the budget. True, exports had performed better in the slack season of 1968–69 but the Governor felt it was not practical to expect the improvement in exports to be of such an order as to meet the heavy debt service liabilities. Anticipating that the budget, too, would be affected by the sizeable shortfall that then appeared likely in PL480 assistance, the Governor forewarned the Central Board and the government that the Fourth Plan (1969–74) would in all probability have to start on a low base.

The immediate economic consequence of reduced aid was the long shadow it cast on economic planning in the country. Longer-term planning was suspended, and three Annual Plans were executed with a view to consolidating short-run gains before the next phase of growth was initiated. Here, a passing reference to Jha's perceptive advice to the Deputy Chairman of the Planning Commission, Professor D.R. Gadgil, on the approach to the Plan is worth recapitulating. In a personal communication, Jha warned that a rigid Plan targeting high growth rates could lead to frustration because 'what gets highlighted is not what is achieved but the shortfalls'. From a technical and psychological point of view, it was better to have a Plan whose targets could be overfulfilled—a Plan that promised certain minimum results and may go beyond it. Another pragmatic suggestion was: 'Our aid requirements should not be seen as an index of our dependence but as a measure of what we can achieve, if the nature and quantum of external support was adequate.' Stressing that aid-giving countries find it far more difficult, economically and politically, to refinance past loans than to sanction new ones, Jha suggested that reliance on foreign capital—official and private—should be reduced to the minimum, and a limited amount of foreign investment should be accepted only for projects deemed as important.

The RBI Governor also briefed the Bank's Board on the impressions he had formed during a visit to Japan. He attributed the Japanese misgivings about India's ability to service her external debt to their leanings in other directions, particularly towards promoting development in Burma, Indonesia and the Philippines. The Japanese interest in India, he said, was confined to proposals that were commercially advantageous to the Japanese economy, like iron ore, for Japan was hoping to become the world's second largest producer or exporter of fertilizer and fertilizer plants on credit terms. Japan and Germany were countries not enamoured by the US and British philosophy of aid, but with the Americans becoming aid-weary, their leverage in pressing Germany and Japan to increase their share in the aid cake was reduced.

On Eastern Europe's role as an aid giver, the Governor informed the Board that the Soviet Union was no longer insistent on turnkey projects. With the new political set-up, accompanied by tighter discipline, his reading was that resort to switch trading and other 'smart merchandising practices' would be contained. The Bank Board's reaction to the Governor's remarks was that it provided an excellent opportunity for Indian business and industry to expand production and fill the breach. Palkhiwala, eminent lawyer and Board member, added that native ingenuity should be given a chance by adopting greater flexibility in administration.

At the Committee meeting held on 13 November 1968, the RBI Governor made a reference to McNamara's impending visit to India. He indicated that McNamara would not be discussing the financing of specific projects but was interested in getting a first-hand picture of India's socio-economy. It was recognized that India needed funds on a soft-term basis and that the appropriate agency for that was IDA; however, the availability of funds hinged on IDA replenishment. Earlier, IDA had financed a wide spectrum of loans including for local currency expenditure and for financing raw material imports. The stoppage of IDA meant availing own reserves for financing the imports of raw materials. So far the reserves had held well, but with the impending debt service payments, anxiety grew that the pressure on reserves could become unsustainable.

A related policy issue that bothered the Indian authorities was the World Bank's attitude towards local versus global tenders. Its insistence on global tenders, it was felt, adversely affected local industry, which was in a position to fabricate plant and machinery. The World Bank appreciated the Indian viewpoint and conceded that price preference in favour of Indian suppliers would be limited to 27 per cent, as this represented the average rate of import duty on (imported) machinery. Some movement towards softening the terms of World Bank lending was in evidence but favourable consideration of the various suggestions depended not only on McNamara, but also on the views of countries providing the major share of funding to the World Bank. Here, the troubled IDA negotiations were a stumbling block, for it entailed the use of tax dollars.

McNamara's visit to Delhi gave little insight on the World Bank's prospective assistance to India. Contrary to press reports, there was no specific discussion except that contributions from other countries should be energized to replenish IDA resources. His discussions were centred on rural savings, rural unemployment and exports. Aware that the Vietnam war had shattered the foreign aid constituency in the US and unhitched virtually all the familiar geopolitical moorings of US foreign policy, McNamara was in no position to make a commitment. He listened and expressed curiosity and interest but remained noncommittal. A friend of India, his six months' military stint earlier in Calcutta, to plan the flow of supplies across the Himalayas into China, had given him a first-hand insight into the aftermath of the Bengal famine, and the great extremes of poverty, hunger and deprivation. And so, the determining consideration for him was the needs of the developing world. But he also recognized that the World Bank could not handle the job by itself. 'I do not believe', he told the World Bank's Governors while addressing them at the annual meeting of 30 September 1968,

> that the Bank can go it alone and do the job of development that needs to be done around the world by itself; but I do believe that it can provide the leadership in that effort, and can show that it is not resources which are lacking—for the richer countries amongst them have resources in plenty—but what is lacking is the will to employ those resources on the development of nations.

Through utterances such as these, he sought to prod the conscience of the richer nations.

At that point in time, the World Bank had a large share of official debt disbursed and outstanding in India. India depended almost entirely on the World Bank and IDA for its multilateral borrowing. The reduction in IDA lending meant a significant loss of concessionality in India's overall borrowing programme.

Reverting to the debt relief request that the authorities were vigorously pushing for—the granting of relief of $100 million for each of the three years 1968–69 to 1970–71—enabled India to postpone payment of roughly one-fifth of the scheduled debt. However, debt relief was counted as part of the total external assistance provided under the framework of the consortium. Postponement of debt service released free foreign exchange. This was the first occasion when debt relief was viewed in a long-term development context. But the volume of net transfer diminished sharply during the three years in which debt relief was provided. The implications of the US aid fatigue was the constraint it placed on the development journey India had embarked upon. Long-haul cases were given a short shrift. The World Bank group was not willing to get involved in governments' anti-poverty programmes such as those for drought-prone area development or employment generation schemes for rural unskilled labour. The assault on poverty remained an unfulfilled dream.

There were many on the Reserve Bank's Board, like Saraiya and Kamaljit Singh, who felt that the answer to reduced foreign aid was to adopt more aggressive export policies. Seized of the need to promote exports, in June 1968, the Governor requested Bank of Japan to depute an expert to study export credit problems and suggest improvements in the system. The terms of reference given to the Japanese consultant, Yoshiaki Toda,[5] were explicit: (i) the problems arising in assisting exporters of new products and exporters with a relatively small turnover, (ii) the present costs of export credit, and (iii) the mechanisms of Reserve Bank refinance from the point of the adequacy of incentives provided in it to banks for expanding export credit. Toda had wide-ranging discussions with officials of the Reserve Bank, Export Credit and Guarantee Corporation (ECGC), Ministry of Finance, the IDBI, leading bankers, and a wide cross-section of exporters. Several gaps and weaknesses in the system were identified but Toda's final evaluation was that 'the Indian export credit system was one of the best conceived by central banks in the world'.

His key findings were that the cost of credit was somewhat on the high side and that, in order to give better incentive to commercial banks to sanction a larger quantum of credit, the Reserve Bank would do well to reduce its concessional rate of refinance for export credit, and also delink the rate from the Bank rate and fix it in the vicinity of the call money rate (viz. 3.5 per cent).[6] Finding that bankers were not happy with the working of the interest subsidy scheme, which they regarded as cumbersome, Toda's preference was for a lower rate of refinance and scrapping of the interest subsidy scheme. He also saw the need for abolition of the minimum rate or at least for maintaining a sizeable spread between the minimum and maximum rates, and giving the banks freedom to charge varying rates within the ceiling. To safeguard exporters from risks taken against foreign currency depreciation, the suggestion was made that the Reserve Bank should consider providing satisfactory forward cover for long-term contracts. The existing regulations on the availability and maturity of packing credit limited packing credit advances to 90 days. Bearing in mind that the future composition of the export basket would be slanted in the direction of the manufacturer exporter, a general extension of the maturity period to 180 days was suggested, through an amendment of the Reserve Bank of India Act. To enable exporters to meet international competition a more positive approach on the part of ECGC and deferred payment terms of three to five years (even up to 8 years) were suggested.

[5] Yoshiaki Toda was administrative assistant to the chief, Coordination Department, Bank of Japan.

[6] Under the inter-bank agreement then in force, the minimum rate of interest on export lending was fixed at the same level as the ceiling rate fixed by the Reserve Bank, i.e. 6 per cent.

Several suggestions for streamlining and simplifying the export credit system were also mooted. But on the core suggestion to delink the Reserve Bank export refinancing rate from the Bank rate, and to fix it at a low enough rate, as well as to scrap the interest rate subsidy scheme, the RBI was not ready to take the plunge. In the Bank's thinking, it was a substantive change that raised a number of issues of a monetary and budgetary character, which required careful study and coordination with the Ministry of Finance. On several of the procedural and constricting policy aspects, however, the Bank initiated immediate action. The amendment of Section 17 (3A) the Reserve Bank Act, which made it possible to provide refinance to banks for a period of 180 days, initiating studies on each exportable commodity, etc. Meanwhile, wide publicity was given to the report and a summarized version of the findings and suggestions for improvement of the export credit system was presented in the shape of a memorandum to the Board. The Board accorded its broad approval to the recommendations. The full text of the report appeared in the February 1969 issue of the Bank's *Bulletin*.

Aware that provision of finance for the promotion of exports was a complex issue, at one of the Central Board's meetings, Jha sought the Board's views on some aspects of the Toda report. Looking at export financing procedures, the expert from the Bank of Japan had pointed out that concessional rates ceased to be effective if banks were not indebted to the Reserve Bank. To get this benefit, banks had to borrow all the year round and unless the cost of borrowing from the Reserve Bank for this purpose was less than the cost to a bank of raising money from the public, there would be no incentive for banks to borrow from the Reserve Bank. On the other hand, bankers pointed out to the Governor that the existence of ceiling on interest rates to the priority sectors acted as a disincentive to banks in expanding credit to other sectors. The dilemmas and discontent that surrounded the export credit policy prompted the Governor to seek the views of the Bank's Board.

Reacting to the Governor's remarks, I.G. Patel, the government's nominee on the Bank's Board said: 'Our objectives have to be clear—whether Bank lending to exports should be more or export finance be made cheaper.' If the emphasis was on the first objective, the earning margin to banks should be higher; if it was the second, then there was need to ensure that lower rates were passed on to borrowers. Further, the policies followed would have to tie in with the objectives of overall monetary policies. He also made the point that in providing money to commercial banks, the Central Bank should not cheapen it to a point whereby the banks' incentive to mobilize deposits was blunted. Deputy Governor B.N. Adarkar cited the Japanese experience: the Bank of Japan provided export refinance at 3.6 per cent, which was cheaper than the cost to banks of raising funds through deposits at 5 per cent. If similar concessionality of refinance for exports was provided to Indian exporters throughout the year, there was every likelihood that they would borrow from the Reserve Bank for exports and deploy their own funds elsewhere.

The Reserve Bank was beginning to move ahead of the Ministry of Finance in its thinking on these issues but was not sufficiently confident to develop a clear alternative to Delhi's entrenched position. The Bank and the treasury were still dominated in their approach by the public utility model of banking, in which heavy regulation was a substitute for competitive processes.

At this point, a brief look at the emerging contours of the country's external payments position might be in order. As noted, the 1966 devaluation failed to bring about the needed improvement in the trade deficit owing to extraneous circumstances such as drought and reduction of external assistance. The first visible signs of improvement became evident towards the close of 1967–68, when the reserves benefited from a net borrowing of $33 million from the IMF, a debt relief of $46 million extended by the World Bank and RBI's net purchase of $201 million from authorized dealers. The combined impact of these transactions was an increase in the net foreign exchange reserves of $80 million during 1967–68. The improvement continued into 1968–69. However, between November 1968 and end, March 1969, there was no net accretion to the foreign exchange reserves owing to repayment of $78 million to the IMF and a refund of $8 million to the IBRD of special deposits. For the year 1968–69 as a whole, the official reserves recorded a rise of $51 million and stood at $769 million at the close of March 1969. If these special transactions were excluded, the increase in reserves would have amounted to $144 million—the highest annual increase in reserves. A surplus of export earnings and invisible receipts over payments for imports and invisibles aided the recovery. The external balance was restored rapidly and somewhat unexpectedly as a result of a severe cut in imports, particularly of foodgrains, and an increase in exports of items like engineering and metallurgical products. In the Reserve Bank's assessment, the decline in imports was due not only to the impact of the recession in industry but possibly represented progress towards import substitution.

There were, however, some who doubted whether the improvement in the export performance could be sustained. Board member Biren Mukherjee, in the course of a Board discussion on the external sector, pointed out that the export performance was impaired as industry was often exporting at a loss. His anxiety was how long could this continue. There were others like Mafatlal who felt there was considerable scope for cost reduction and improvement in productivity. It was evident the major concern of the Board was the uncertainty regarding availability of raw materials for industry, and the need for orientation of the government's policy towards making available raw materials at stable prices to enable industry to maintain the growth in exports. All that the Reserve Bank's memorandum on the current economic situation sought to bring out was that the initial uncertainty with regard to exports following the devaluation of the rupee had been overcome, that there was a better awareness of the need for exports, and that industries were building up the requisite organization and capacity.

Returning to the global scenario, 1967–68 was a historic year, in the sense that there were distinct signs that the post-war economic order was undergoing a fundamental change. The clearest indication was the growing shortage of international liquidity in relation to the volume of world trade under the conditions of exchange rate stability imposed by the Bretton Woods system. Throughout most of the 1960s, both the US and the UK had experienced chronic balance of payments problems and both the reserve currencies—the pound sterling and the US dollar—were under intense pressure. Eventually, the UK was forced to devalue on 18 November 1967, triggering a chain reaction that culminated in the abandonment of the Bretton Woods system some four years on.

As noted elsewhere, India retained its gold parity and the impact of the sterling devaluation on the country was limited. The RBI Governor apprised the Bank's Board that the total loss of the Bank's and government's holdings of sterling assets was a little more than Rs 10 crore, amounting to about 4 per cent of total assets excluding gold. This by no means could be considered large for a country like India which was an important member of the sterling area. He added that that policy of diversification adopted a few months earlier had helped to contain the loss. The increase in the UK Bank rate was also likely to impact favourably on investment income earnings of India's holdings of sterling assets. The Governor's assessment was that some real loss arising from the 4 per cent expected increase in UK prices would have to be reckoned with, assuming that the UK would secure a 10 per cent competitive advantage from the devaluation.

This, however, did not mean that the RBI Governor was complacent about the future of sterling. During his visit to London in mid-1968, Jha had talks with Haslam in the Bank of England, Douglas Allen in the

Treasury and Wilson in the Overseas Development Ministry. The purpose of the talks was to explore current thinking on the future of the sterling area. It was a known fact that some sterling area countries had been trying to get assurances from the UK in regard to their sterling balances, to protect themselves against the risk of further devaluation of the sterling. But at that point the British maintained that they had given no assurance to any independent country and all had agreed to continue as members of the sterling area in view of the advantages the arrangement brought to them. The talks also confirmed that the general behaviour of the sterling area had shown no discernible change in the pattern of holdings, except for the Middle East countries who now held less of their reserves in sterling as the UK was paying for its oil in sterling IOUs. There was, however, a school of thought within the British Treasury, no doubt among the younger breed, that the sterling area under prevailing conditions was an anachronism and more a liability than an asset to Britain. But this was discounted by the older generation of bureaucrats.

One of the consequences of the rupee and sterling devaluations was growth of awareness in the business community regarding the need for covering forward exchange risks. Although this consciousness was universal, the demand for forward exchange from importers was less than the offerings from exporters, leaving commercial banks with a large amount of surplus dollars and not enough demand in the local inter-bank market to dispose them. The only available option was to sell the surplus sterling proceeds so acquired to the Reserve Bank, which, under its statutory obligation, stood ready to purchase all the sterling offered to it at parity. Such accumulation of sterling was, however, considered undesirable in the circumstances of considerable uncertainty regarding the future of the sterling. As the underlying rationale was that acceptance of this risk was in the public interest, the Reserve Bank, in July 1966, decided as an experimental measure to mop up the dollar offerings, using the agency of the State Bank of India to purchase, on the RBI's behalf, spot and forward dollars up to six months delivery. An interesting, perhaps unintended fall-out of the arrangement was the emergence of the US dollar as a component of India's foreign exchange reserves.

The Basle facility removed the selling pressure to a large extent from the sterling and for the next three years or so, the currency entered a period of stability. In this period the focus of attention shifted to the US dollar. The period immediately following the sterling devaluation saw a surge in demand for gold. The US lost about 20 per cent of its holdings and was forced to back out of supporting the gold pool, which had been designed to maintain the price of gold at US$35 per fine ounce. At the same time-agreement was reached on establishing a two-tier gold price under which official monetary transactions would be effected at the official gold price of $35 per fine ounce. The US trade position slipped further in 1968–69, paving the way for a full-blown crisis in the early 1970s. Thus, while the Basle facility played an important part in propping up the sterling, this had to be seen in the context of growing uncertainty about the future value of the world's leading reserve currency, the US dollar, which ultimately triggered the demise of the par value system.

TURBULENCE AND UNCERTAINTY IN INDIA'S BALANCE OF PAYMENTS POSITION

So far as India was concerned, the period 1968–69 to 1970–71 was a period of consolidation with the reserves showing consistent improvement of more than 40 per cent. But the period of consolidation was shortlived, for 1971–72 witnessed far-reaching changes both in the Indian subcontinent and outside. Events moved fast and drastically that year, culminating in the emergence of Bangladesh as an independent country. This imposed a heavy strain on the Indian economy, first in the form of an inflow of refugees, who at one stage numbered 10 million; second, through the rapid escalation of defence expenditure; and third, in terms of disruption of aid and trade relationships. Government of India faced a daunting dilemma: whether it could absorb the 10 million refugees or more without seriously disrupting the economy of India, more notably that of West Bengal, and would it invite the wrath of the superpower who was constantly warning India against intervention in Pakistan.

Added to this, major world powers were at work. The most significant of these power realignments was the détente between the US and China, resulting in the entry of the latter into the United Nations fold. The Moscow agreement between the US and the USSR further changed the political equations in Europe and Asia. Equally devastating were the developments on the monetary front. Convertibility of the US dollar was suspended in August 1971 and its value was allowed to depreciate until its formal devaluation under the Smithsonian agreement of 18 December 1971. As a consequence of the devaluation of the dollar, there followed a spate of devaluations of other currencies, which included, among others, Pakistan, Nepal and Sri Lanka—India's neighbours and close trading partners. In late 1972, the pound sterling was allowed to float and exchange controls were imposed by the UK, which struck a fatal blow to the sterling area. India, however, retained its link and allowed its currency to float with the pound. The position of the US dollar turned out to be even worse than that of the pound sterling. Continuous growth in the US trade deficit and misgivings about the US administration's ability to deal with the situation forced the dollar to devalue for a second time within a period of fourteen months. With sharp fluctuations in currency values and South Africa's policy of withholding gold supplies, the international prices of gold reached phenomenal heights.

These radical developments totally altered the circumstances in which developing countries like India had to function and progress. In the face of the unfavourable international developments, Indian representatives—Jha, I.G. Patel and Narasimham—valiantly carried forward the debate on readjustment of policies to benefit trade and development in foras like the UNCTAD and the IMF. I.G. Patel attended a conference in New York on International Monetary Reform, organized by Sidney Dell of UNCTAD, at which he presented his ideas on the feasibility and desirability of creating an international reserve that needed no backing except the will of the international community.

Throughout 1971 the Reserve Bank kept abreast of the developments in the international markets and the consequential action taken by the Indian government.[7] Based on the findings of a study presented by the RBI's Economic Department on 'The Dollar Crisis and India's position', the Bank's Board discussed the impact of the US surcharge on India's exports and concluded that the bulk of Indian exports, except engineering goods, would not be affected by the surcharge. Since only 15 per cent of India's trade, at best, would be affected, tactically it was felt that there was no strong ground for seeking its withdrawal; instead, seeking bilateral negotiations on specific commodities was recommended. Alternative possibilities of devaluing or floating the rupee were also discussed but, for a variety of reasons, were regarded as not appropriate under the circumstances, and the wait-and-watch approach was endorsed.

On the domestic front, initially, at least till December 1971, the events of 1971–72 showed no significant evidence of the strains caused by the refugee influx, the natural calamities that affected several parts of the country and the war with Pakistan. The economy displayed considerable resilience in meeting the challenges. Current spending in the economy was more or less matched by the large stocks of agricultural commodities inherited from the unusually good crop of 1970 and intensive utilization of available aid

[7] For details, see the chapter on Exchange Rate Conundrums.

funds. As industrial capacity was available, the special needs of defence were taken care of through additional production. Skilful monetary and fiscal management helped to contain speculative activity and promoted relative price stability. In the event, between end-June 1971 and end-December 1971, the general price index showed a nominal rise of 1 per cent, despite an increase of Rs 320 crore in the net indebtedness of the government in the banking sector and Rs 726 crore in aggregate monetary resources. Foreign exchange reserves, too, showed some improvement following the disruption of jute exports from East Pakistan. The country appeared to have taken in its stride the new challenges posed by declining net foreign aid, the increased requirements for defence, and the assumed responsibility for aiding the reconstruction and rehabilitation of the new state of Bangladesh. While there was evidence of proper economic management at a time of immense strain, the events probably affected the development programme as a result of the diversion of steel, transport facilities and chemicals for defence purposes. As it turned out, there was no great pressure on the rupee during 1971–72 despite the larger import surplus, the bulk of which was financed by aid funds rather than any drawal of reserves. With repurchases of $65 million in March 1971, India eliminated all outstanding debts to the IMF. India's reserves in 1971–72 were aided by the second allocation of SDR 101 million and by the revaluation of gold in December 1971, which resulted in an increase in the dollar value of India's gold and SDR holdings, and its Fund gold tranche position.

On the foreign investment front, with amendment of the Foreign Exchange Regulation Act (FERA), 1947, some changes were made in the measures affecting private foreign investments. These were chiefly aimed at Indianization of foreign-controlled companies. The staff of the Exchange Control Department were required to grapple with drafts and re-drafts of the amendments, taking into account the comments of industry, trade and fourteen ministries.

With the economy in external balance and remaining close to internal balance, one would have thought that the task of monetary policy would have been to facilitate a non-inflationary rate of growth. But the Reserve Bank's Board was clearly uncomfortable with the thought because the economy was already highly liquid and tending to be even more so, on account of deficit financing, on the one hand, and uncertainty about agricultural supplies, on the other. It feared there would continue to be serious pressure on prices, and suggested that the Bank should caution the government of the likely dangers on the price front and urge it to carefully estimate its requirements. Initially the budget provided Rs 60 crore for expenditure in connection with the refugees. But, as it turned out, the inflow of refugees was much larger than anticipated; to meet the expenditure on refugee relief, supplementary demands for grants were presented in August and December 1971, totalling Rs 200 crore.

Since April 1971, the Reserve Bank had been keeping a watchful eye on the happenings in East Bengal and its impact on the Indian economy, and it was mentally prepared for additional draft on account of rehabilitation and assistance to refugees coming from East Bengal. In September, during a Board discussion on the price situation, Executive Director Pendharkar, while explaining how the monetary situation would affect prices, asserted that expenditure on Bangladesh refugees had not contributed to any rise in prices so far, as the government itself was procuring and supplying food to the refugees.

In January 1972, introducing a note prepared by the Economic Department of the Bank on 'Bangladesh: Economic Problems and Prospects', the RBI Governor pointed out to the Board that Bangladesh needed both material and technical resources but that the government had decided it would wait till the Bangladesh authorities formulated their requirements. The Bank's study indicated a deficit of Rs 125 crore in Indo–Bangladesh trade; a Board member queried if this meant that India should provide that much capital to Bangladesh and, if that was so, whether India would either have to produce more or divert its exports from other countries to Bangladesh. It was clarified that in certain commodities like coal and cement, it would be possible to export to Bangladesh without slashing Indian exports to other countries. The immediate, short-term requirements of Bangladesh were for drugs, pharmaceuticals, engineering goods and cloth. Also, tremendous advantages would flow from economies in transport costs following the reopening of inland waterways in Bangladesh. After all, India had considerable scope for enlarging the number of commodities that could be mutually exchanged.

Seshadri pointed out that the currency problems of Bangladesh would need to be resolved, for Bangladesh Bank would have to take over the note issue liability and would need the backing of some foreign assets. The immediate problem, however, was both an accounting and a substantive one. The Reserve Bank recognized that it was an abnormal situation, for it was not an orderly partition of assets and liabilities between the governments or between the Central Banks, but recognized that solutions would have to be evolved to meet the specific circumstances. Against the backdrop of these developments, the slant of the 1971–72 busy season credit policy was towards enabling the banks to meet, on a priority basis, the additional credit needs of industry to manufacture and supply goods for defence purposes, and to ensure smooth distribution of goods in the border areas. Through the grant of defence packing-cum-supply credit limits against confirmed orders or acceptance of tenders, the Bank effected limited relaxations in its credit policy, and sought to accommodate the financial requirements of the industrial units in the eastern sector. At the same time, the Bank was wary that a steep rise in credit levels had the potential to create a climate unfavourable to price inflation.

This growing concern about domestic prices was not misplaced, for 1972–73 witnessed a spiralling rise in the price level. As the year progressed, it became evident to the authorities that this was not a transient or seasonal phenomenon, and that physical and monetary factors were operating together to undermine price stability. Discussion of the deteriorating price situation dominated all else at the weekly meetings of the RBI's Central Board. The tendency was to overlook the favourable developments that had occurred in fiscal 1972–73. Despite the disturbed international monetary conditions, India's exports had recorded sizeable gains and, despite the sharp rise in imports, its level of foreign exchange reserves had remained virtually intact. In the Reserve Bank's assessment, the positive and negative developments had to be jointly evaluated; with the advantage of hindsight, it is evident that what emerged was an amalgam of natural, structural and institutional causes that widened the gap between the current flows of supply and demand in the economy.

In the sphere of external transactions, the improvement recorded in 1971–72 could not be maintained in 1972–73. Whereas, in 1971–72, the major factors facilitating an increase in reserves were the sharp reduction in the trade account deficit and the allocation of SDRs, in 1972–73, the balance of payments moved into deficit, even though there was a surplus in the balance of trade. The main reasons for this latter deterioration were a further decline in net foreign aid and the fact that a substantial part of the increase in exports related to shipments of food and other necessities to Bangladesh on a grant basis. Another point that deserves to be mentioned in connection with the movement in reserves is the increase in the rupee value of reserves by Rs 38 crore, consequent upon the floatation of world currencies. In both 1971–72 and 1972–73, there was a decline in foodgrain output, which led to a surge in prices and resumption of imports in 1973. In both these years, economic growth was barely 2 per cent.

Looking to the performance of exports over the decade of the 1960s, the Reserve Bank was distinctly pessimistic about the dramatic increase estimated in the rate of export growth. Aware that the rate of growth of Indian exports was less than the rate of growth of world exports and even less than the growth rate of exports of less developed countries, the Bank's management gave the Bank's research work a sharper edge, by commissioning analytical studies on exports—commodity-wise and country-wise—to locate the demand and supply constraints facing Indian exports. The studies attributed constraints to problems inherent in the commodity composition of Indian exports, that is, a heavy dependence on exports for which income elasticity of world demand was comparatively low (tea) or which were subject to severe competition from substitutes (jute manufacturers). In order to remedy the unfavourable position, Deputy Governor Krishnaswamy, during the Article XIV consultations, assured the IMF team that Indian efforts were increasingly directed towards changing the commodity composition of its exports.

In 1972–73, for the first time in many years, a trade surplus was recorded, resulting from a 7 per cent expansion in exports and a 12 per cent contraction in imports. Special circumstances aided the export performance, such as the world boom in commodity prices. Currency realignments rendered Indian commodity prices competitive in world markets and increased commercial exports to Bangladesh. On the other hand, there was a distinct slackening in the rate of non-traditional exports during 1972–73; exports of engineering goods had suffered from the shortage of steel and inadequate availability of credit. Changes in forward exchange cover arrangements, the feasibility of which the Reserve Bank had been considering for some time, could no longer be postponed, it was realized, particularly if Indian exports of engineering goods had to compete effectively in international markets.

For some time now, there had been a demand from exporters for a scheme of forward exchange cover extending over the entire period of the contract. The RBI was convinced of the justification of the demand. The then existing arrangement allowed exporters to take a short-term cover for six to nine months and seek extension at best for twelve months, and to roll it over on maturity. Such roll-over, the Bank recognized, was not only expensive but failed to protect the exporters against changes in exchange rates over the entire period of the contract. As early as 1971, as an important measure of export promotion, the Bank designed a scheme to provide forward cover to exporters making exports on deferred payment terms, and forwarded the same to the Ministry of Finance for its consideration in February 1971. However, the turmoil in currency markets around the world and the considerable uncertainty about realignment of exchange rates following the 15 August 1971 announcement and closure of currency markets, forced the Finance Ministry to temporarily shelve consideration of the scheme.

In January 1972, the Ministry of Finance set up a Working Group comprising officials from the Ministry of Finance, the Ministry of Trade, the ECGC and the Reserve Bank, to examine the need for such a facility and to make detailed recommendations for introduction of a suitable scheme. The Working Group endorsed the views of the Reserve Bank that there was need for such a scheme, that the scheme should cover all goods shipped on deferred payment terms, and that the scheme should be operated by the Bank. On rates to be charged, the guideline given was, they should neither be so low as to cast a heavy burden on the Bank nor so high as to rob the facility of its utility; a maximum margin of 2.5 per cent over the Bank's spot buying rate for pound sterling was suggested. The Bank had proposed a scale of rates with a maximum margin of 4 per cent over the Bank's spot buying rate for a deferment of ten years. To ease the burden on the Bank of operating the scheme, the Working Group suggested that the difference between the rates proposed by it and those suggested by the Bank should be made good to the RBI by the government out of the Market Development Fund.

The Finance Ministry was supportive of the recommendations of the Working Group and informed the Reserve Bank that it was keen to have the scheme brought into operation at an early date. However, due to continued crises in foreign exchange markets abroad, some hesitancy was evident on the part of the Bank to do so. It was only in mid-1974 that the RBI commenced providing long-term forward exchange cover in respect of exports of goods on deferred payment terms, the proceeds of which were denominated in pound sterling, US dollar, deutsche mark and Japanese yen. The need to introduce a scheme to extend a forward cover facility to exporters participating in international tenders also engaged the attention of the Bank. Hitherto, authorized dealers could provide forward cover to exporters only against firm orders. Realizing the limitation of such a scheme, the Bank remodelled it so that it would facilitate the exporter bidding for the contract.

Towards the middle of 1973, the government was distinctly uneasy about the prospects of the external payments position in the coming years. With rising inflation, depleting levels of foodgrain stocks,[8] sharp hike in prices and increased debt servicing, the prevailing view in the government and

[8] Government stocks of foodgrains reduced from 9 million tons in July 1972 to less than 3 million in March 1973.

the Reserve Bank was that fundamental instability and disequilibrium would again emerge in India's external accounts. They also believed that some of the instability could be removed by sensible use of macroeconomic tools including reinforcing reserves through IMF borrowing and resumption of imports of foodgrains. Having decided to terminate the imports of foodgrains under PL480 in end-1971, the rapid decline in foodgrain stocks compelled the government to purchase, on a crash basis, 2 million tons of wheat from the USSR in the early part of 1973.

In June 1973, Manu Shroff, officer on special duty in the Ministry of Finance, shot off an urgent message to the Indian Executive Director, Prasad, at the Fund, to immediately arrange for a drawing in the region of SDR 100 million from the IMF to pay for the foodgrain imports. Prasad, after consultations with the staff and head of the Asia division, informed Shroff that if the government so wished, India could avail of a drawing under the compensatory financing facility (CFF) and that the IMF would be ready to consider such a request. Elaborating that the assistance was additional and meant to be used by members experiencing balance of payments deficits arising from a shortfall in their export earnings, Prasad invited the attention of the government to the fact that drawings under the facility would not affect the amounts a member could draw under its gold or credit tranches. Conditionality associated with CFF drawings, too, was mild. The main requirement was that the drawings should help finance shortfalls from a medium-term trend in export earnings. On a rough-and-ready basis, the IMF staff made some calculations and confirmed that India could qualify for a CFF drawing.

The response from the government was negative. It was not interested in considering a CFF drawing, which, in its view, would not be sizeable. It therefore saw no reason to go through the drill of providing commodity-wise forecasts for the two post-shortfall years. Further, there was a political aspect to be taken care of, for, in discussions on the external payments position in the Lok Sabha, the Finance Ministry had consistently held out that exports were increasing. Now, if the government were to avail of the CFF drawing, explanations would have to be provided on how and why there was a shortfall, when the government was all along projecting an underlying growth trend in exports. It was to avoid this embarrassment that Finance Ministry officials were reluctant to consider the CFF option.

But, convinced that India's balance of payments need in the coming period would exceed gold and first credit tranche drawings, Prasad continued his efforts to convince M.G. Kaul, Secretary, Economic Affairs, and RBI Governor Jagannathan on the CFF option. After several exchanges between the Executive Director's office and the Finance Secretary (Kaul), the latter agreed to allow the head of the Commodities Division at the IMF, Duncan Ridler, to visit the Finance Ministry and the Reserve Bank to discuss computation of the export shortfall. Although Finance Ministry officials remained lukewarm to Ridler's visit, the RBI presented the Indian case in a positive light using a good deal of flexibility in the interpretation of the decision by suggesting an adjustment in the export statistics of substantial shipments to Bangladesh financed from grants provided by the Indian government. Because of the special nature of the shipments, the bulk of which were essentially re-exports of goods imported by India during the period under consideration, the IMF staff, despite the fact that no precedent of such adjustment existed in other compensatory drawings, took the line that it was in accordance with the purpose of the facility to exclude the value of such shipments from the determination of trend and shortfall. On this basis, Duncan Ridler was able to convince the top management of the IMF of his assessment of a shortfall of SDR 62 million using the export forecast method.

All along, the approach of the IMF staff to the India drawing was positive, the main plank of argumentation being that the shortfall was largely 'attributable to circumstances beyond the control of the member'. In the face of such persuasive reasoning, Economic Affairs Secretary M.G. Kaul, after consultations with the Finance Minister, informed the Managing Director of the IMF and the Indian Executive Director that the Indian authorities would shortly request a purchase of the equivalent of SDR 62 million under the CFF decision, in respect of an export shortfall for the period ended 30 June 1973. The Board considered the request on 13 February 1974. Most of the Directors agreed that the request was in the spirit of the facility rather than the letter of it, for, in essence, the exports to Bangladesh were grants. Many conceded that the adjustment relating to Bangladesh aid was a novel application of a compensatory request but described it as a 'sensible' one. The majority viewed the exclusion as reasonable and one warranting exceptional treatment. Only one Director expressed some technical misgivings, although he characterized the request as 'genuine and modest'. Prasad, while thanking the Board for its wholehearted support, sought to remove misgivings with regard to adjustments pertaining to Bangladesh aid by explaining that India provided aid to Nepal, Sri Lanka and Mauritius, but since this was aid of a regular nature, no adjustments were made for it. On the other hand, the Bangladesh operation was essentially of a different nature—it was an operation of self-denial of domestic consumption.

The cooperative attitude of the IMF management and staff and the tenacity of the Indian Executive Director in persuading the seniormost echelons, both in the government and the Reserve Bank, resulted in a satisfactory outcome: they helped, for the time being, to retain the gold tranche (SDR 76.2 million) and first credit tranche (SDR 235 million) for use at a later date.

That date was not far off, for, within two months, India had to approach the IMF again. Just as the economy was emerging from drought conditions, made possible by the 1973 bumper autumn crop and large foodgrain imports, the country was severely affected by the international oil crisis. The difficulties on the external front were further compounded by the high prices of a number of primary raw materials and supply shortages of strategic inputs such as fertilizers, with the prices of nitrogenous fertilizers rising threefold between 1970–71 and 1973–74. The foreign exchange outlay in 1974–75 on oil imports alone was placed at $1,300 million, as against $625 million in 1973–74. A large external payments deficit loomed on the horizon and, in the face of the highest rate of inflation since independence, the immediate preoccupation of the authorities was to improve the supply deficiencies both in the agricultural and industrial sectors, and to considerably reduce the rate of price increase. Thus India was faced with both an internal and external economic problem.

Two converging developments helped Prime Minister Indira Gandhi face the crisis. The first was the publication of a book by V.K.R.V. Rao,[9] entitled *Inflation and Economic Crisis* which provided a general outline of a way to solve the internal crisis; the book's recommendations became the essence of Mrs Gandhi's policies.[10] The second was financial aid from the IMF and the World Bank. By April 1974 Indian authorities concluded a major financing package with the IMF to cover the balance of payments deficit, and by June negotiated a major loan from the World Bank's Aid India consortium. In order to secure these, Indira Gandhi had to prove that the Indian authorities had a policy that would stabilize the economy. Without such a programme, as one senior Finance Ministry official remarked, 'We would not have been able to achieve either the IMF loan or the aid package.'

The policies recommended by Rao and endorsed by P.N. Dhar—money supply reduction, wage freezes, increased imports, strong exports and

[9] V.K.R.V. Rao was an economist at the Institute of Economic Growth, Delhi.

[10] That this document became the basis of her policies was confirmed by P.N. Dhar and C.H. Hanumantha Rao. See Jeremiah Novak's article, 'The Role of IMF, World Bank', published in the July issue of the *Asian Mail* (USA) and reproduced in the *Times of India* of 1.7.1977.

freeing of private capital—fitted neatly into the IMF and World Bank conditionality requirements, and were developed with a view towards the negotiations. Accepting them meant that Mrs Gandhi had to give up her pre-1974 policies, which were dubbed as quasi-socialist, but she had little choice. The opposition bitterly criticized her but, hiding behind the cover of the Rajasthan atomic test, she concluded the April 1974 negotiations with the IMF.[11] Before she could sign the loan agreement, Mrs Gandhi had to crush the railway strike, which she did with a firm hand, but for political reasons she could not announce that she had switched to a western model of development.

In view of the low consumption levels, the degree of manoeuvrability to switch resources away from consumption to productive investment and enlarged exports was distinctly limited, even though the Indian authorities were determined to traverse the difficult adjustment path. The massive deterioration predicted in the country's external accounts for 1974–75, indicating an uncovered financing gap of SDR 621 million, was sought to be partially covered by further drawings from the IMF of SDR 76.2 million in the gold tranche on 17 April 1974, and a request for a first credit tranche purchase from the Fund of an amount equivalent to SDR 235 million, which came up for Board approval on 1 May 1974. In processing the request, the IMF staff indicated that in the present situation, 'the only realistic goals for 1974–75 would be modest increases in agricultural and industrial production, slowing down of the inflation rate, a significant growth in exports and a gradual shift from imported fuel to domestic energy'. The letter of intent accompanying the request for the drawing clearly demonstrated that the objectives of the government coincided with those of the Fund.

The government and the Reserve Bank were serious about their task in designing the programme for 1974–75, which was in support of the drawing. They zeroed in on three inter-related tasks: first, a reduction in the rate of price inflation, which was 27 per cent for the twelve-month period ending March 1974; second, an adjustment of the balance of payments and the economy to the recent sharp increases in petroleum and fertilizer prices; and third, achievement of a satisfactory rate of growth. Some elaboration of these three areas of policy will go to show the determination with which the Indian authorities braced themselves to meet the adjustment challenge. Guided by the need to control inflation, the government's fiscal policies were framed with the aim of sharply reducing deficit financing. To this

[11] On 20 May 1974, the *Far Eastern Economic Review* signalled that the Indian economy was on the verge of a major overhaul.

end, the 1974–75 budget curbed not only non-developmental expenditures but even development expenditures. This was no doubt regrettable but inevitable. The budget for 1974–75 assumed a receipt of no more than Rs 4.98 billion from market borrowings and a reduction in food subsidies well below the level of fiscal 1973–74.

Against the background of large-scale deficit financing by the government, the Reserve Bank was faced with difficult decisions on its credit policy stance. The Governor met with his senior staff several mornings each week to review the monetary trends. Credit restraint was felt to be necessary but not to such a degree as to throttle production, and curb investment and exports. From 1972–73, the credit policy was progressively tightened, but, because of the high degree of liquidity, attributable mainly to the government deficits, commercial banks were able to substantially expand credit. In its credit policy for the 1973–74 busy season, the Bank sought a firmly restrictive stance. Major reliance was placed on a ceiling on expansion of bank credit for purposes other than food procurement. However, by December, it was evident that this ceiling was unlikely to hold. The partial success in the implementation of ceilings forced the Bank to reinforce its restrictive monetary stance by adopting a slew of additional measures at the end of November, covering an increase in the minimum lending rate from 10 per cent to 11 per cent, an increase in statutory liquidity requirements and an increase in the margins on advances.

The Reserve Bank's decision not to freely provide accommodation to banks, coupled with other measures, gave rise to a situation of extreme credit stringency and a sharp flare-up in the call money interest rates, which ruled as high as 30 per cent in the second week of December 1973. At no time before had the economy experienced monetary conditions as tight as those in force during the busy season November 1973–16 April 1974, and yet, by early January, it became evident to the Bank that the quantitative ceiling set for the busy season would be breached. Despite a cloud hanging over the effectiveness of its tight monetary stance, the Bank, while retaining the essential features of monetary control, recognized the ground realities and allowed for some credit expansion, to take care of the rising inventory costs in the industrial sector as a result of higher prices, by reducing the cash ratio by two percentage points. A discretionary element was introduced into the new policy, in that both the quantum of credit and the rate of additional finance for food procurement and financing of imports of crude were to be determined by the Bank. The move towards greater flexibility was understandable but added responsibility was cast on the monetary authorities to maintain greater vigilance in operating a tight monetary policy. There was a strong lobby at the IMF that was pressing hard for the need to pursue a dear money policy and advocating a more aggressive use of the interest rate instrument, arguing that the nominal high interest rates had been rendered negative in real terms as a result of price increases. But the Bank preferred to move cautiously. The Indian Executive Director, in his defence of the Indian authorities' policy stance, pointed out to the IMF Board that interest rates had been raised all along the line and, even though exports was a priority sector, the rate for export credit had been raised. The Bank, after careful consideration, remained of the view that the burden resulting from the increase would be insignificant, as the cost of credit for exports formed a very small element of total exports. Nevertheless, from then on the interest rate became an important instrument of monetary management.

On the balance of payments front, there was general acceptance of the fact that but for the increase in the price of oil and fertilizers there would be no financing gap, and that, apart from the oil facility, the increase in fertilizer outlay of SDR 375 million meant that India would have access to resources larger than allowed for under the oil facility. International economic policy was the subject of intense discussion within official circles. Although the government had an eye on the oil facility, in view of the debt burden, which was already substantial, it was reluctant to incur fresh debt and preferred to limit external borrowing to the minimum. This helped to keep the country's debt profile at manageable and sustainable levels, and created a favourable impression on the international community. Thus the package of adjustment measures put in place to progress towards achieving balance of payments viability in the medium term received the approval of the Board, and support for a first credit tranche drawing of $235 million was given. The bottom line of the IMF staff's assessment was that: 'in the light of food scarcities, crucial importance of fertilizers for agricultural production and high degree of unutilized capacity in industry, the authorities had acted correctly in planning to maintain the level of essential imports', and, while continuous adaptation of trade and payments policies was warranted, 'long-term aid on highly concessional terms will be essential'.

While briefing the government and the Reserve Bank on the tenor of the discussion and clearance of the request, Prasad, in the final paragraph of his letter, informed them that the request to retain the deutsche mark component without converting into dollars had been granted, on the assumption that the currency was needed for making future payments. Accordingly, it would be appropriate for the Reserve Bank to keep this fact in mind and not utilize it as an opportunity to diversify foreign exchange reserves.

The thrust of his advice was accepted and the Bank, in its deployment of foreign exchange reserves, respected the spirit of the Fund's rule *in toto*.

In July 1974, at Bangalore, Mrs Gandhi announced the new policy, which included impounding dearness allowances along with impounding profits. According to P.N. Dhar, the Bangalore speech was a 'critical moment in our policy', for it announced the beginning of a new era. But Bangalore was a beginning without a follow-through. Ruddar Datt, in his *Indian Economy* (1976), summarized the situation well.

> Attempts to control prices since the Bangalore speech[12] in July 1974 had borne fruit and the general price level was falling, but the government could not take advantage of the situation and consolidate its control over inflation. By June 1975, the economy was poised to take a deep plunge. The various steps taken by the government against tax dodgers and smugglers were thwarted by the courts on technical grounds. Many welfare measures the government brought . . . did not succeed due to opposition of the vested interests. . . . Superimposed over these economic problems was the political instability arising out of the revolt of the opposition and the internal dissentions in the ruling party.

As recounted earlier, the unprecedented rate of inflation constituted the central problem of the economy in 1973–74, overshadowing all else. And the central issue that emerged from the performance of the economy in 1974–75 was restoration of a modicum of stability and balance in the economy. Good economic management through adoption of fiscal, monetary and administrative measures helped to bring prices down from the high levels recorded earlier, and, together with steps to improve the availability of raw material supplies and relieve transport bottlenecks, enabled the resumption of industrial growth and investment despite a decline in domestic savings. But probably the key element in the return to stability was the buoyancy in export earnings despite the deterioration in India's terms of trade and the sizeable inflow of external resources. This gave the authorities the ability to import the necessary raw materials and appropriately augment the aggregate supply. But there was a growing strain on India's

[12] According Jeremiah Novak, Ruddar Datt saw clearly how what began in Bangalore as the IMF programme needed the Emergency to be fully implemented. 'Bangalore and the Twenty-Point Programme are related', said P.N. Dhar, and so were the IMF–World Bank programmes related to the Emergency.

foreign exchange reserves stemming from the rising import bill: the reserves recorded a drop of Rs 176.2 crore during the half year ended December 1974, despite their replenishment by Rs 192 crore towards the end of October 1974 by drawals from the IMF.

1974–75 was technically the first year of the Fifth Five Year Plan. The attempt to judge the performance of the economy by the Plan yardstick of savings, investment and growth, as admitted by the authorities, was far from satisfactory, for there was barely 1 per cent real growth in the national product. But, as rightly pointed out in the Reserve Bank's *Annual Report*, it was incorrect to evaluate the performance in terms of targets. The fact that had to be reckoned was that the economy had inherited massive problems in the preceding couple of years, disrupting the long-term growth process. Again, 1974–75 had its own share of natural calamities and the domestic difficulties were compounded by external factors, namely, the quadrupling of oil prices and rise in world prices of foodgrains and fertilizers, imports of both of which needed to be stepped up. Thus, in the Bank's judgement, 'the restoration of normalcy in itself becomes an impressive achievement'.

HANDLING OF THE OIL CRISIS

The oil price explosion in the last quarter of 1973 brought into sharp focus the spectre of a worldwide crisis, reminding the global community that supplies of crucial raw materials were finite and the days of availability of cheap energy had abruptly come to an end. It portended massive shifts in international payments positions and a slowdown in economic activity at a time when inflation in all countries, particularly industrial countries, was at historically high levels, and posed a setback to the development aspirations of developing economies.

The redeeming feature was that the new Managing Director of the IMF, Witteveen, reacted with great alacrity to the oil crisis. At two-day meeting of the Committee of Twenty (C-20), convened in January 1974 at Rome, he mooted a proposal to introduce a temporary oil facility. The need for the closest international cooperation was solicited in the management of dramatic international payments changes arising from higher oil prices, and the Rome communique urged countries to avoid competitive depreciation and escalation of restrictions on trade and payments. There was genuine apprehension that adoption of deflationary policies to curb payments deficits could spiral into a serious global recession. With missionary zeal and determination, Witteveen confronted the massive and startling disequilibrium in international payments that faced the global economy;

he realized that adjustment for many of the developing countries would not only be painful but well-nigh impossible.[13]

Witteveen took pains to avoid any outward manifestation of his dominant role. He encouraged the Board members to speak out on issues and presented them with a growing flow of issue papers and action programmes. The oil facility was not conceived as a panacea for the deterioration in the payments situation. It was seen as a transitional bridging facility to tide over temporary difficulties, till more lasting adjustments could be worked out. An official arrangement to recycle petro-dollars was envisaged; but even this limited concept met with stiff resistance, especially from senior officials of the US Treasury, who, while conceding that the situation was unmanageable, were unwilling to consider any such option. The thrust of the US strategy rested on the belief that concerted international pressure should be brought to bear on the oil exporting countries to roll back a large portion of the price increase. At the same time, oil consuming countries should undertake the needed adjustment to reduce their demand for imported crude, and increase production and use of alternative sources of energy. The US was confident that adoption of such a policy would bring down the price of oil in a remarkably short time. In its view, agreeing to Witteveen's proposal would send out wrong signals that the international community was ready to absorb the hike in oil prices. The Germans, too, were reluctant to lend support to Witteveen's proposal or to lend to the IMF. Their objection stemmed from the belief that injecting liquid resources into the world economy at a time when inflation was on the rise was not the wisest course of action. The Fund's senior staff was also wary that it would unnecessarily cast a heavy financial burden on the institution.

Despite the heavy odds, following the mandate given by the C-20 at the January 1974 meeting, Witteveen took a trip to the Middle East in search of borrowed funds. Once he received assurance of financial support, he ventured to gain US support. Seeing that the developing oil importing countries were leaning on oil exporting countries for bilateral financial support and not vociferously objecting to the oil price increase but exploring ways to overcome the resulting payments deficit, the attitude of the US to the proposed oil facility softened.

Nothing like the oil facility existed in the IMF. The first half of 1974 saw the Fund work feverishly hard to give shape to the facility. Procedural, policy

[13] In a speech to the World Banking Conference in London on 15 January 1974, Witteveen warned that the international monetary system was facing its most difficult period since the 1930s. *IMF Survey*, Vol. 3, 2 January 1974.

and legal issues had to be addressed; terms and conditions for drawing and arranging credit lines had to be approved by the Board. The specifics of conditions of use, formula for determining access, charges on the use of funds and format for entering into borrowing agreements, all had to be addressed.

By mid-March 1974, the proposals of the Witteveen facility were given to the Board, where the first airing of views seemed to show consensus that the facility should be so designed as to primarily benefit the developing countries but not to the exclusion of the developed countries. Prior to the discussion in the Fund Board, Prasad, in a secret message to the Reserve Bank and the government, gave them the broad contours of the proposed facility, which was examined closely by both. V.B. Kadam, Director, Balance of Payments Division, RBI, was assigned the task of examining the proposals. In a detailed, well-argued note, Kadam proposed that, in principle, the scheme should be supported with pressure for early action. But the RBI had reservations on the assumption of an increase in cost of oil of only US$5.50 per barrel. The note questioned whether the assumption of a uniform increase in oil prices was appropriate in defining the extent of the strain on a net oil importer's balance of payments, and urged that some allowance be made in the formula for the proportion of direct imports. The other area where change was sought related to the matter of charges. Here, the RBI pressed the need for differentiation between developed countries and developing countries, in keeping with the differences in the ability to absorb increased oil costs through economy in oil use, through substitution by other energy sources and through increases in export earnings. For the developing countries the charges should be substantially lower than those for the developed countries, and, in any event, should not exceed the charges on the Fund's normal drawings. The RBI scrutinized every aspect of the proposal in the minutest detail but adopted a positive approach that would assist quick establishment of the facility.

Turning to the Indian scene, with the quadrupling of crude oil prices of imported petroleum products, the pressure on domestic prices intensified, as a significant proportion of those products was utilized by industries constituting the infrastructure. Apart from its bearing on the price situation, the oil crisis also had implications for balance of payments and growth. Initially, however, the precise implications were unclear. The Reserve Bank's preliminary estimate was that the annual import bill would be in the region of Rs 1,000 crore, accounting for virtually half the export earnings, as against Rs 275 crore in 1973. There was no reason to believe that reduction in imports of 17 million tonnes of crude oil and 3 million tonnes of petroleum products would not have adverse repercussions on growth. There was every reason to maintain monetary tightness. For the rest of 1973–74, the Reserve Bank held firm. The suggestion by the IMF that the interest rate notch should be tightened further was resisted; the demand of industrialists for relaxation was played with an equally dead bat.

Looking ahead, the Reserve Bank and the Treasury concurred that there were two directions in which further efforts needed to be concentrated. First, exploration of offshore and onshore oil should be intensified. Second, the possibility of substantially increasing the use of coal as a source of energy should be examined. There was, therefore, no disagreement that the energy situation had to be tackled on a war footing. The initial response to the increase in international oil prices in October 1973 was to reduce consumption of petroleum products through an increase in domestic price rather than through rationing devices. Beyond a point, this strategy had its limitations but despite this, the government continued its efforts at reduction of petroleum consumption through the offer of financial incentives to firms switching from petroleum to coal. Oil exploration efforts were expanded and private companies were invited to participate in oil exploration projects. At the same time, the domestic refinery capacity was slated to be increased. In retrospect, it cannot be denied that the structural adjustment measures undertaken by the government to adjust to the oil price rise were pragmatic initiatives in the areas of production, distribution and pricing. Admittedly, in the short run, the scope for reduction of petroleum use was limited, but the discovery around that time of offshore oil off the coast of Bombay, added a glimmer of hope to an otherwise grim scenario. It remained to be established whether the oil find was a commercially viable proposition.

As early as February 1974, while the IMF was struggling to give final shape to the creation of a special oil facility, the Indian Executive Director at the Fund informed the Finance Ministry that, based on the increase in the oil import bill minus 20 per cent of a member's reserves, and applying the price increase of US dollars 5.50 per barrel, India's entitlement, according to the Fund's calculation, would amount to Rs 379.2 million.[14] To draw on the facility, the member had to demonstrate need. While initially the

[14] The formula used to calculate the entitlement was as under:

1972 import	125 million barrels
Computed increase	SDR 569.9 million in import cost
Less one-fifth of the reserves	SDR 190.7 million
Amount available for drawing	SDR 379.2 million

conditionality attached to the drawing may not have been stringent, in subsequent years the drawings could attract stiffer conditions. Repayments would start three years after the drawing in sixteen quarterly instalments, and the interest on the drawing was fixed at 7 per cent.

The Finance Ministry's initial reaction was that such a facility that entailed short-term borrowing at 7 per cent it was not an attractive proposal. The officer on special duty, Shroff, made a cryptic remark: 'Our concern is with softer terms—lower rate and longer repayment, otherwise this facility will remain one we cannot use.' Another valid point to which Shroff drew the attention of the Finance Secretary was that, while the estimated drawings of the developing countries would be in the neighbourhood of SDR 1.3 billion, the developed countries' drawings were expected to be in the region of SDR 11 billion. Questioning the rationale for lending such large sums at concessional rates of interest to the developed countries, Shroff legitimately suggested a higher rate of interest for the developed countries and an easier maturity pattern for the developing countries. But concessional lending with differential interest rates was opposed by most of the industrial countries; as a result, proposals for subsidization of the differential between borrowing and lending rates through the Fund's income or reserves, or through the creation of a special issue of SDRs, were outright rejected.

The element of inequity in the architectural structure of the facility bothered Shroff, who remained critical of the scheme. But Bimal Jalan, also a senior officer in the Ministry of Finance, saw merit in supporting the establishment of the special facility. His basic reasoning was that, to the extent the facility helped the developed countries to meet their credit requirements without resorting to deflationary policies and competitive depreciation, it was in the global interest. The totality of the global scenario, of avoiding a major recession, prompted Jalan to be supportive. Agreeing, however, with Shroff that India needed concessionary finance, his evaluation was that it could be a useful source of supplementary finance, provided the rates were favourable to those of commercial borrowing. In short, Jalan was not for outright rejection but wanted the Executive Director to push hard for a differential interest rate, longer maturities for developing countries, adoption of equitable rationing criteria for use of the available funds, and some kind of guarantee that the use of the facility would not adversely affect existing resource collection.

The then Economic Adviser, Manmohan Singh, too, was not happy at the way the proposals were shaping up and felt that they were not an adequate solution to the problem. He requested Prasad to push hard for some of the changes suggested by the Reserve Bank and the government. But, in the face of the fairly rigid and uncompromising attitudes adopted by the oil producing and other developed countries with respect to the financing aspects of the facility, as well as the Fund's Legal Department insisting that the Articles of Agreement required charges to be 'uniform for all members and differential charges were not feasible', Prasad's job of seeking concessionary finance was rendered almost impossible. Although the IMF charging commercial rates of interest was foreign to its nature, because the facility had to be based on borrowed funds, as the Fund was already operating at a budgetary deficit, there was no way that the oil facility could be given out below the cost of raising the funds. RBI Deputy Governor Krishnaswamy also indicated that a flat increase of $5.50 per barrel was not appropriate in measuring the magnitude of the strain on net oil importers' balance of payments and some adjustment needed to be made for direct imports to total imports. The assumption of 125 million barrels for India was an underestimate, as it did not take into account the requirements of petroleum products like fertilizers. But, despite Prasad's valiant efforts to drive home the plight of the non-oil developing countries, and urging the MD to explore the possibility of two types of loans—hard and soft, he was unable to extract any special concessions for the non-oil developing countries.

On 13 June 1974, after prolonged sessions to give shape to the oil facility and to resolve the related issues of valuation of SDR, interest rate on SDR, charges and remuneration, the IMF Board approved the decision establishing the facility. The next issue that came up for consideration was: should India borrow under the oil facility? Aware of Delhi's reservations on the terms and conditions, Prasad made a strong plea to the government to avail of the drawing, and to use the money for building a small buffer stock of wheat or reinvest the amount in the Euro-dollar market, for he was convinced that, sooner or later, money would be needed. Anticipating a queue to develop because of the mild conditionality attached to the 1974 drawing—the time having been short to whip up specific adjustment programmes—Prasad urged Delhi to request a drawing. But Manu Shroff advised the Finance Secretary, M.G. Kaul, that the cost of buying time was likely to be in the region of 10 per cent of the amount drawn, which appeared excessive to the government. True, the facility was available only for a limited period and, if unused, would lapse. But the projected debt service burden of Rs 1,100 crore in 1979 excluding repayment of the oil facility drawing, coupled with the high interest rate and bunching of repayments, acted as deterrents to a drawing. In view of the large deficit projected in the foreign exchange budget for 1974–75, the Executive Director was instructed by Delhi that 'India was interested but had not so far taken a policy decision to draw.'

Prasad ventured to address a letter directly to the Finance Minister, Y.B. Chavan, stating that, despite his best efforts, it had not been possible to persuade lenders to place their funds at less than 7 per cent but that he would continue his efforts to press for a subsidized lending rate for non-oil developing countries. With little support from the other developing countries, the Indian plea for a subsidized rate fell on deaf ears, and was pointedly ignored by the developed countries. Here, an episode of interest, relating to the Managing Director, Witteveen, is worth narrating. It was Witteveen's conviction that India would need the oil drawing. Despite the Indian authorities' hesitation, he visited India in October 1974. During discussions with the newly appointed Finance Minister, C. Subramaniam, and the Governor of the Reserve Bank, S. Jagannathan, and in meetings with Prime Minister Indira Gandhi and President Fakhruddin Ali Ahmed, Witteveen reasoned that India should avail of the oil facility drawing even if its balance of payments was not so bad, for, by having larger foreign exchange resources at its command, India could relax somewhat the highly restrictive import policy that was stifling growth; additional imports could foster economic growth. The irony of the episode was that, even before Witteveen was back in Washington, India had drawn SDR 200 million under the first oil facility and, through additional imports, recorded a brisker rate of growth in 1975–76.

Hardly had the newly arranged oil facility been put in place then Witteveen was seen moving in the direction of creating another and larger facility for 1975. He was perceptive enough to realize that the need for recycling petro-dollars would remain big in 1975. Already, the commercial banks of industrial countries were channeling enormous sums of money through the Eurodollar markets. There was, however, a real danger of these banks going overboard and endangering their liquidity position through overexposure. This pushed Witteveen to find ways of strengthening official financing outlets for oil deficits; in his opening address at the 1974 annual meeting of the IMF and World Bank, he made a forceful plea for setting up a second oil facility that would help the non-oil developing countries to undertake structural adjustment measures to contain their oil deficits.

Even before the discussion on a second IMF facility for 1975 could get off the ground, the US opened a diplomatic offensive by floating the Kissinger proposals[15] for a new $25 billion oil facility outside the Fund. It

[15] The 14 November 1974 address of Secretary of State, Henry Kissinger, before the Board of Trustees of the University of Chicago.

was obviously an attempt on the part of the US, if not to torpedo the IMF facility, to reduce its role. The key feature of the US plan to recycle petrodollars was that financing for importing by industrial countries hard hit by oil prices should be done under the aegis of the Organization for Economic Cooperation and Development (OECD), rather than the IMF. Loans under US financing would be tied to the following conditionalities: a commitment to cut back on the use of imported oil, avoidance of retaliatory restrictive trade policies, sharing of risks by all OECD members on the basis of their share participation in the Fund. The main elements of the US cooperative strategy were to reduce oil imports, develop alternative energy sources and reduce consumption of oil. That was not the end of it, however, for, Kissinger, who had masterminded the strategy, suggested the establishment of a separate 'trust fund' with the IMF that would take care of the needs of the most severely affected (MSA) group of countries. The funding for the trust fund would come from contributions by Organization of Petroleum Exporting Countries (OPEC) members and other sources, and from the sale of gold by the Fund in private markets; profits from the sale of gold by the Fund would be lent to MSA countries on concessional terms.

The plan, no doubt, held out some attraction for the oil producers who could get market-related rates for the placement of their funds and whose risks would be guaranteed by the industrial countries. But the reaction of the MSA Directors was one of serious concern. Replacing an IMF facility, which operates for the entire international financial community, by a series of discrete mechanisms raised the fear of a very serious departure from international solidarity. Prasad, the Indian Executive Director, urged that the new proposal should not relieve the IMF of its responsibilities towards its entire membership and, therefore, that it was better to centre the adjustment process in the institution rather than split the process into two compartments—the IMF and industrial countries. Besides, several aspects of the gold problem had to settled first before one could count on this source to meet the laudable objective of concessionary finance.

At the OECD meeting, the US Treasury Secretary, Simon, spelt out the details of the proposed financial safety net—the OECD commitment to the second oil facility would have to be in the region of $25 billion in 1975. The Secretary General of OECD, Van Lennep, came up independently with a similar proposal, in which, instead of each OECD member contributing to the common fund, there would be a guarantee arrangement by the Bank for International Settlements (BIS). The upshot of these proposals was that the Executive Board was requested to consider the mechanisms and other details; in short, to give flesh to the various ideas floating around and pencil the outlines of an oil facility acceptable to the majority of members.

The mandate given to the Board was not easy to execute: there were both arguments and counter-arguments on the size of the facility, the source of finance, the list of trust fund beneficiaries, even the very concept of an oil deficit, which was described as an imperfect concept and radically resisted by the US. Ultimately, through the maze of different viewpoints, on 23 December 1974, the bare bones of the 1975 oil facility were settled upon by the Board and forwarded to the Interim Committee for approval. Several issues remained to be settled, however, and the Interim Committee had the uphill task of arriving at acceptable compromises and giving the lead to enable the IMF to get the 1975 oil facility in place. At its meeting in Washington, the Interim Committee, after some debate, wisely threw out the safety net idea for industrial countries and more developed countries, and instead, decided on another facility in the Fund, open to all members. The proposed loan and guarantee financing facility elaborated by the US Treasury did not find favour with the Europeans.[16] On the other hand, the oil countries were attracted to this facility, as it would give them an instrument of investment that was guaranteed by powerful nations.

The US opposition to the oil facility in the IMF was confined mainly to its use by developed countries. If the Fund could discriminate and create an oil facility only for developed countries, the US objection would have disappeared. In fact, the trust fund idea was mooted to help the developing countries. Thus, after intensive debate, the broad features of the second oil facility remained broadly the same as for the 1974 facility, but with a provision that the concessional rate of interest would be applicable to countries more severely affected.

On 4 April 1975, the requisite decisions to establish the second oil facility were taken on the following terms: assistance would be available for seven years; charges would be raised marginally to 7.75 per cent[17] to meet not only administrative costs but also provide a fair return to the lenders making resources available to the Fund; some relief in charges would be

[16] France opposed the arrangement as the scheme was confined to members of the International Energy Agency and required that the beneficiaries aim at curbing consumption of oil. It was reluctant to join a cartel of oil consumers.

[17] Charges on Transactions under the 1975 Oil Facility

(Charges in per cent a year payable on holdings in excess of quota for period stated)

Up to 3 years	7.625
3–4 years	7.750
4–7 years	7.875

provided to the most seriously affected among the oil importing developing countries. But access to the 1975 oil facility was subjected to a much stricter degree of policy conditionality than was applicable to the 1974 facility—a prospective borrower was required to give more specificity to its programme of oil energy conservation and utilization to achieve medium-term balance of payments adjustment, including greater use of the exchange rate policy. Although India and several other non-oil developing countries were unhappy and expressed their concern at the tightening of the conditionality, they were attracted to the concessional feature of the facility. The Latin American group was sorely disappointed and Kafka, the Brazilian Executive Director, remarked to the Indian officials that 'middle-income countries were left in the cold'. India drew SDR 201.34 million in 1976; thus total drawings by India under the two oil facilities aggregated SDR 401.34 million. Although the majority of the members did not sign the voluntary pledge, the most advantageous fall-out of the conditionality prescriptions was that members refrained from introducing further trade and exchange restrictions, which made adjustment to the oil crises somewhat smoother.

In sum, the skewed distribution of global energy supplies and the need for redressing world payments imbalances that may continue for some time to come, brought to the fore the need for some relief in charges to be provided to the most seriously affected among the oil importing developing countries. The idea of the IMF charging commercial rates was foreign to the Fund's traditional philosophy of relatively low charges coupled with conditionality. It may be recalled that during the discussions relating to the creation of the second oil facility in 1975, the Indian Executive Director had made a strong plea to soften the burden on developing oil importing members of charges as high as 7.7 per cent a year, but the Executive Directors had found it hard to agree.

At the 1974 annual Fund–World Bank meeting, the Governors of both developed and developing countries spoke in favour of a subsidy account in the Fund to provide relief from high charges to the developing countries; this was later endorsed by the Interim Committee. Based on the Interim Committee's directive and understanding that such an account would be set up, the Executive Board considered the staff proposal that fleshed out the idea of such an account. It was accepted in principle but, in practice, establishing such an account turned out to be an uphill task. The job entailed finding satisfactory explanations to such issues as, could the Fund, under its Articles, differentiate charges among various categories of members. Hitherto, the charges were the same for all members, as the Articles specified that they had to be uniform across members. The IMF staff paper addressed this issue and indicated that there was no legal bar to the Fund offering a separate schedule of charges to a floating facility that existed independently of the regular facility.

The other issue was, who should qualify to receive the subsidy. After extensive debate, it was decided to use the UN list of thirty-nine countries, identified as the most seriously affected members (the MSA list). This included all three members of the Indian constituency, viz. India, Bangladesh and Sri Lanka. Contributions to the subsidy account were solicited from all members, including oil exporting and industrial countries and excluding MSA countries. Switzerland and twenty-four members were contributors to this account. The US remained the most conspicuous non-contributor. A subsidy at the rate of 5 percentage point was maintained for the fiscal years ending 30 April 1976 and 1977. This reduced the effective average cost of using the resources from that facility for MSA countries from 7.71 per cent to 2.71 per cent. The MSA countries received a subsidy equivalent to SDR 13.8 million in 1976, SDR 27.5 million in 1977 and SDR 24.9 million in 1978. Of these, the subsidy received by India amounted to SDR 7.23 million in 1976, SDR 10.03 million in 1977 and SDR 7.46 million in 1978. Because of a sizeable improvement in India's balance of payments resulting in a salutary rise in monetary reserves, during May 1977 to April 1978, under the Fund's normal requirement of Article V, Section 7(b) relating to repurchase, India was required to repurchase its outstanding under the 1975 oil facility, indicating that the receipt of subsidy had ceased. To sum up, despite the enormous difficulties in setting up the subsidy account, its creation was an innovative and path-breaking step signalling greater flexibility in the IMF's operations.

Till 1972–73 India consciously eschewed the path of medium-term borrowing, but, between 1972–73 and 1974–75, as India's deficit on trade account grew, India was forced to resort to large-scale medium-term financing, essentially to finance the increased costs of imports for its current consumption of petroleum, foodgrains and fertilizer. The first such medium-term arrangement was for a wheat loan of 2 million tonnes from the USSR. This was a commodity loan in the sense that its repayment had to be in wheat. In matters pertaining to external aid and negotiations for medium-term credit, as a general rule, the government preferred to pursue an independent and characteristically more direct approach. Although no representative of the Reserve Bank was associated in the negotiations for the wheat loan, Narasimham, an RBI officer who had just assumed office as Additional Secretary in the Department of Economic Affairs in the Finance

Ministry, was included in the official team.[18] The core of the negotiations related to details about the matching quality of wheat for repayment and the modalities of the exchange. The Indian side, in the face of acute shortage of foodgrains, emphasized the urgency of expediting the shipments; this request was met by diverting supplies intended for Chile and on the high seas, to Bombay.[19] Within weeks of the negotiations, the first shipments of Russian wheat were available for government distribution.

In the case of the first oil credit negotiations with Iran in 1974, Economic Secretary M.G. Kaul requested the RBI Governor to nominate a Bank official as a member of the Indian delegation. The Bank nominated the deputy manager, who was well versed in banking law and practice; he provided valuable advice on the banking aspects of the credit arrangement. At the outset, it seemed that the Iranians were not ready to discuss the terms of the credit but were more anxious to finalize the oil supply deal. But diplomatic pressure was applied from the Indian side and full-scale negotiations followed. The initial arrangement proposed by the Iranian side was that the Central Bank of Iran—Bank Markazi—would extend credit to the Reserve Bank of India to finance the purchase of oil. The Reserve Bank representative was quick to point out that under the RBI Act, it was not permissible for the Bank to borrow from sister Central Banks for any period longer than one month. Therefore, Government of India would be the borrower and the Reserve Bank would manage the credit as an agent of the government.

At a later meeting, it was agreed to make the credit procedure simpler by making the Iranian Oil Co. extend the credit directly to Indian Oil Corporation, with a suitable guarantee from Government of India (a supplier credit type arrangement). But there was hard bargaining on the price at which the crude oil would be supplied—Iran refused to budge from the posted price—and the rate of interest to be paid. It later transpired that the Iranians were insistent that the Reserve Bank should give an undertaking that foreign exchange would be released on the due dates for repayment of credit and payment of interest, as well as join in the State Bank of India's obligation for remittance of the amounts on due date. While the RBI had no difficulty regarding the release of foreign exchange, it informed the

[18] The delegation was headed by P.N. Dhar, then the Prime Minister's Secretary, and included, besides Narasimham, the Food Secretary and the chief executive of the Food Corporation of India.

[19] M. Narasimham, *From Reserve Bank to Finance Ministry and Beyond: Some Reminiscences*, p. 61.

government that it was not legally permissible for the Bank either to guarantee due repayment of the credit by Indian Oil Corporation or join in any guarantee that the State Bank of India may give in this regard.[20]

In the agreement that was eventually signed, credit was directly given to Indian Oil Corporation without the government's intervention. This had two major implications—firstly, the government did not get any budgetary support; secondly, Indian Oil Corporation, which was the recipient of the credit, was required to cover itself in respect of the exchange risk, as there would be a difference between the sale price it would realize within India on distribution of the products and the rupee cost of the deferred instalments in foreign exchange, when the credit was liquidated. As it turned out, the Reserve Bank's involvement was minimal, as the banking aspects of the arrangements were taken care of by the State Bank of India.

Reverting to India's external accounts, the effects of the oil price increase and the dramatic deterioration in the terms of trade that had taken place since 1973 did not show up fully in the balance of payments position before 1974–75. Until 1973–74 the foodgrain deficit was largely filled by drawals from government stocks built up during periods of good harvests. The effects of the oil price increases were not reflected in the actual payment statistics before the first quarter of 1974–75. The 1974–75 balance of payments revealed a current account deficit of only Rs 955.7 crore, despite in the import bill for petroleum, foodgrain and fertilizers showing an enormous combined increase of Rs 1,265.9 crore.[21] Despite this increase, the overall deficit was contained at a sustainable level through a large increase in exports, a higher level of gross aid and continuation of a savagely restrictive import policy. Use of IMF resources in the region of SDR 497 million in 1974 and some medium-term borrowing, including the medium-term credit of $ 132.25 million from Iran for the import of oil, helped to prevent a sizeable drawdown in reserves.

[20] Government of India was prepared to issue the necessary guarantees but Iran was insistent on bank guarantees. Guarantees of the State Bank of India were offered but the National Iranian Oil Co. wanted such guarantees confirmed by the Reserve Bank.

[21] (Rs crore)

Imports	1973–74	1974–75
Food	473.9	794.8
Mineral oils	340.2	1112.4
Fertilizers	125.2	298.1
	939.3	2205.3

The Indian authorities were now faced with the difficult task of medium-term adjustment. While some marginal reduction in imports was contemplated through the adoption of energy policies and through increased agricultural production, the major thrust of the adjustment policies was directed towards promoting exports. It was recognized that the problem had to be dealt with imaginatively and skilfully; restraining imports would retard economic growth, while higher levels of medium-term borrowing could eventually land the economy in a debt trap. Keeping these factors in mind, the onus was thrown on promoting exports, for it was recognized that monetary and fiscal mechanisms were unequal to the task of protecting export capability or capacity. The government, however, was well aware of the need to rationalize export promotion measures. A study was already under way of the experience with export promotion measures. A Committee on Engineering Exports (Sondhi Committee) had issued a report in 1974, calling, among other things, for a sharp de-emphasis on export obligation as a means of encouraging exports and, in general, applying greater selectivity of both items and production on which to focus the export drive. A Cabinet Committee on Exports was set up to suggest further improvements in the export incentive system. This Committee gave effect to some of the Sondhi Committee proposals, notably increases in cash assistance, a reduction in penalties for certain types of export obligations and simplification of procedures for steel allocations. But these measures were applicable only to engineering exports. Other far-reaching measures included variations in export duties—export duties on jute manufactures were cut and a system of direct cash assistance for selected non-traditional export items were announced as part of the export promotion measures.

The Reserve Bank, too, was seized of the need for improved monetary mechanisms to promote all exports. In April 1975 it created an export cell to attend to various aspects relating to the provision of export credit by banks and to the administration of the Export Credit (Interest Subsidy) Scheme of 1968. The cell was to serve as the secretariat of the Standing Committee on Export Finance—a high-powered, policy-formulating body for matters pertaining to export finance. K.S. Krishnaswamy, then Deputy Governor in charge of the Economic Department, was the chairman of the Committee.[22] The Standing Committee met for the first time on 9 April

[22] The other members of the Committee included representatives of the Ministry of Finance, Ministry of Commerce, Industrial Development Bank of India, Export Credit Guarantee Corporation, Foreign Exchange Dealers' Association of India, and representatives from the Economic Department and Exchange Control Department of the Reserve Bank.

1975 and several times thereafter. Some valuable suggestions flowed from its deliberations. These were taken up for further examination by the export credit cell. Some of the procedural issues examined by the cell to see if they needed adjustments to facilitate export growth, were: the schedule of collection charges in respect of rupee bills, with a view to making such bills attractive; the need for extending post-shipment credit at a concessional rate for up to 120 days; the question of the Reserve Bank providing refinance to banks against sight bills; the types of export items for which concessional pre-shipment could be granted for more than 270 days. Based on the findings of the cell, the Standing Committee requested the Ministry of Commerce to take steps to increase the interest subsidy to banks from 1.5 per cent to 4 per cent in respect of deferred payment exports, and the Ministry of Finance to consider payment of interest subsidy to banks on buyer's credit extended by exporters to foreign importers. The cell acted as a bridge liaisoning between Ministries of the central government, Export Promotion Councils, Exporters' Association, the ECGC and the IDBI, and played a useful role in ironing out policy and procedural wrinkles that came in the way of export activity. It was also instrumental in building a databank on all aspects of exports, which acted as a valuable input for policy formulation. Monitoring payments as interest subsidy at the rate of 1.5 per cent to banks was also assigned to the cell. Around this time, Government of India had extended a special line of credit of Rs 25 crore to Bangladesh at a concessional rate of interest of 5 per cent per annum, for the supply of capital goods to that country. The Reserve Bank was called upon to maintain and administer this account, an additional responsibility that it willingly undertook as an agent of the government.

Around mid-1975, the regular Article XIV consultation on India was scheduled for discussion in the IMF Board. Article XIV is an annual consultation between member and the IMF Board for getting the IMF's seal of approval on the economic policies followed by a member country. That year the IMF staff report placed the developments in the Indian economy in a favourable light and commended the vigorous policy measures taken by the government to curb inflationary pressures. However, although the report was appreciative of the difficulties in managing a vast economy, in its detailed analysis of the developments of the economy (the RED, as it is referred to), it was highly critical of Indian policies relating to exports, private investment, tax administration and the exchange rate. This dichotomy between the tenor of the main report and the RED puzzled Jagannathan, the newly appointed Indian Executive Director on the IMF Board. He was in a quandary as to how to defend some of the *ex-cathedra* statements made in the report and sought the views of the Indian authorities. It was his maiden performance and he was keen to defend India's economic policies effectively. To get the reactions of the authorities, he sought postponement of the scheduled meeting to discuss the India report, from the Secretary's section.

It was obvious to Jagannathan that there had been some political arm-twisting of the IMF staff between the issue of its main report, which was dated 9 June, and the RED, which was circulated a month-and-a-half later, on 17 July 1975. So what had transpired inbetween to bring about this unhappy assessment of the Indian economy? All pointers were in the direction of political events in India and the imposition of the Emergency. The Emergency was looked upon by the industrial countries as an assault on democracy and the US, the major shareholder in the Fund, was no longer prepared to give a clean chit to India's economic policies. This disturbed Jagannathan, in whose judgement the staff assessment was not very sound, particularly with regard to the exchange rate. The IMF staff's evaluation of the exchange rate read: 'The authorities have been seeking ways of expanding exports without either a change in exchange rate policy or a major overhaul of the system of controls.' When the 1975 India report came up for discussion in the IMF Board, Jagannathan ably defended the Indian authorities' stance on the exchange rate policy by pointing out that, in relation to major international currencies, the Indian rupee had depreciated significantly since 1972, following the decline in the value of the pound sterling. This depreciation had been helpful to Indian exports (the staff report had conceded this point) and there was no need to consider the rupee as being overvalued to any extent. Citing the enormous increase in remittances through official channels, and the very narrow difference between official rates and unofficial quotations for the rupee, to show that the rupee was not overvalued, Jagannathan demolished the staff argument regarding its overvaluation.

In the light of Jagannathan's spirited defence, the thrust of India's economic policies grudgingly received the approval of the Board. The Board, while conceding that 'vigorous policy measures by the Government were successful in sharply curtailing inflationary pressures', went on to record to say that the fundamental problems of inadequate agricultural and industrial production remain to be solved. Describing the emphasis on increasing public sector expenditures as appropriate, the decision recorded was that 'it will require improvement in the buoyancy of the tax system and more would need to be done to improve the investment climate in the private sector'. Curiously, there was no direct reference on the management of the exchange rate, except an innocuous statement that 'the Fund hopes India will take additional measures to ensure a more rapid growth in exports'. Overall, there was more than a hint in the 1975 Article XIV consultation, of the application of some 'stick' to encourage decisions favourable to the industrial world.

The year 1974–75 is remembered as a year in which normalcy was restored to an economy that had passed through the traumatic experience of unusually high rates of inflation in the previous two years, and in the year 1975–76, it was possible to put the economy back on its normal path of growth in an environment of price stability. The growth rate in real output increased to 5.5 per cent in 1975–76 from the average of 1.2 per cent during the previous three financial years. The demand management measures that contributed significantly to the control of inflation were income policy measures supported by action in the monetary and fiscal fields, such as increases in salaries and wages, increase in dearness allowances and freezing of a portion of incomes in higher brackets in compulsory deposits with the Reserve Bank. The demand-side measures were complemented by efforts to improve supplies. In addition to a good harvest, supplies were augmented through substantial foodgrain imports. Action taken against hoarders also helped to increase the availability of supplies. There was a sizeable improvement in the balance of payments with the current account deficit of Rs 955.7 crore in 1974–75 narrowing to Rs 177.9 crore in 1975–76, and with gross international reserves recording a rise of as much as Rs 864 crore to Rs 1,885.4 crore, at end-1975–76.

Another landmark development influencing the external sector was the delinking of the rupee from the pound sterling on 25 September 1975. The exchange rate system was changed to one in which the value of the rupee was pegged to a weighted currency basket within 2.25 per cent margin on either side. In operating the multi-currency basket, as described in the chapter on Management of the Exchange Rate, the export-weighted effective rate appreciated by about 4 per cent between September 1975 and April 1976. The IMF remained critical of the policy of appreciation but the Indian authorities vigorously defended it by stating that adoption of the multi-currency basket had reduced uncertainty for exporters and importers by stabilizing the value of the rupee vis-à-vis currencies other than the sterling, while increasing the purchasing power of the rupee in terms of the sterling. In the perception of the Indian authorities, the purchasing power parity of the rupee and the competitiveness of Indian exports had improved on account of the favourable price performance of India relative to its trading partners. In a world characterized by violent day-to-day fluctuations, they dismissed as of little consequence a small effective appreciation of the rupee, on the understanding that developments on the export front would be carefully watched. They remained convinced that the change to a basket of currencies had to some extent contributed to the stabilization of prices of imported commodities and services.

Indeed, containment of prices was the single most outstanding achievement of 1975–76. This assessment would be incomplete without reference to a rather unique experience in the management of the economy. The declaration of internal Emergency and the inception of the Twenty-Point economic programme helped to tone up the administration and ensured effective implementation of specific time-bound programmes. There was increased emphasis on discipline and efficiency. Strikes were virtually eliminated and effective action was taken against smuggling, hoarding and tax evasion. Export promotion was given added emphasis. The improvement in the external sector was further reinforced by another international development, the movement in international gold prices, which, in 1975–76, remained under the shadow of expectations regarding the effects of the disposal of 50 million ounces of gold by the IMF. The consensus[23] reached at the Jamaica meeting of the Interim Committee on gold introduced uncertainty in the gold market. This, together with the recovery of the US dollar on the exchanges, induced heavy selling; by the third week of September 1975, gold was traded in the London market at $128.75—its lowest price since January 1974. The downward pressure appears to have touched off large-scale dehoarding and restrained smuggling, and Indian reserves appear to have benefited also from this development.

There were three features of growth in 1975–76 that lent support to the resumption of normal growth after a two-year interregnum of inflation. These were price stability, a significant rise in investment, and a move towards a viable and sustainable external payments position. On the external front, although the trade deficit was much larger than in the previous year, the payments situation underwent a healthy change, primarily on account of larger inflow of external assistance and a sizeable improvement in the invisible account. In the Bank's evaluation, these trends were symptomatic of a structural transformation in the balance of payments components, arising out of higher export capability, import substitution in the sphere of oil and energy, and a sharp step-up in invisible earnings.

[23] The Jamaica accord *inter alia* related to (i) the abolition of the official price of gold, (ii) abrogation of the obligatory payments in gold by Fund members, (iii) immediate disposal of 50 million ounces of the Fund's holding, half by restitution and half by auction.

Although 1975–76 marked the beginning of a favourable phase in India's external payments account, the Reserve Bank, as the guardian of the country's economic health and stability, sounded a note of caution in a memorandum submitted to the Board on 2 February 1976 by K.S. Krishnaswamy, on the 'Current Economic Situation and Outlook'. On future prospects, the memorandum emphasized the fragility of the supply–demand balance in terms of real resources, adding that it had been possible to restore price stability through demand management rather than through domestic supply adjustments. However, with a money supply expansion of 12 per cent recorded in 1975–76, the Bank feared a gradual heating of the inflationary cauldron and bluntly warned that 'any let up in the over-riding objective of demand management and fiscal policies may impair price stability and invite a fresh bout of inflation'.

In the mid-seventies, there were distinct signs that current invisible receipts were becoming a dominant item in the country's external payments account. Several measures were taken in 1975–76 to encourage the inflow of savings from Indians or persons of Indian origin abroad, such as permitting them to open non-resident foreign currency accounts to invest, within specified limits, in a wide range of Indian industries. In fact, there was a sharp shift in remittances from illegal to legal channels following the periodic upward adjustments in the intervention rate against the sterling, which was attributed as a factor that increased the inflow of remittances. But the Reserve Bank's reading was that this inflow was unlikely to be sustained at the levels witnessed in 1975–76. The more liberal and pragmatic attitude taken towards foreign travel and the increased foreign demand for Indian labour services brought about a larger than expected shift in net invisible receipts. According to estimates made by the Exchange Control Department of the Bank, gross non-merchandise receipts through banks alone rose from Rs 654 crore in 1974–75 to Rs 1,198 crore in 1975–76, and surged to Rs 1,586 crore in 1976–77 and further to Rs 2,117 crore in 1977–78.[24] The major components of these receipts were private unilateral transfers, travel receipts, and earnings from technical and professional services including consulting and contracting. Private unilateral transfers primarily represented remittances for family maintenance from migrants living abroad. While remittances from overseas Indians swelled from Rs 31 crore at end-March 1975 to Rs 320 crore at end-March 1978, balances held by Indians abroad with banks in India under the new Foreign Currency Accounts Scheme reached an unprecedented £12.3 million and $149.8 million.

[24] Reserve Bank of India, *Annual Report 1977–78.*

The shift in strategy from tight micro-regulation to one designed to attract and encourage inward remittances through banking channels from persons of Indian origin residing abroad, paid rich dividends. The Reserve Bank's Research Department, through analytical studies and special surveys of various components of the invisible accounts, such as the Unclassified Receipts Survey, Foreign Travel Survey and Foreign Collaboration Survey, was able to make a valuable contribution to the decision-making process pertaining to the invisible sector. No doubt, a combination of factors were responsible for the spectacular rise in invisible receipts. Although a full explanation cannot be attempted here, they included the salutary improvement of the Indian economy with containment of domestic prices at a time when inflation abroad was at a high level; stability of the external value of the rupee while there were sizeable fluctuations in the exchange values of major currencies; increase in the number of Indian workers going abroad in search of gainful employment; the management fees and agency services, along with investment income and technical know-how associated with Indian enterprises taking up a growing number of turnkey projects. Gradual nurturing of the various elements of the invisible account resulted in a phenomenal improvement in net invisible receipts, from a paltry Rs 193 crore to Rs 2,486 crore, in 1979–80.

Here, passing reference may be made to the attempts made in 1976 and early 1977 to woo non-resident Indians by deputing senior bureaucrats to visit the Gulf and South Asian countries with a view to invoking their interest in investing in India. One such high-powered team led by Finance Minister Pranab Mukherjee[25] visited the Gulf, Indonesia, Hongkong and Thailand, and even called on the ruler of Dubai (Bin Makhtoon). The impression gathered by the team was that while the non-resident Indians were keen to invest in India, they were looking for concessions in various areas, the basis for which, the delegation felt, did not yet exist. Indians in Hongkong were uncertain about their future when Hongkong would revert to China, and suggested that the Indian government should seriously consider making the Andaman and Nicobar Islands a free port and an offshore financial centre. To develop the infrastructure of those Islands, Indians in Hongkong suggested that the Indian government float bonds in foreign exchange that they would subscribe to. The Indian team was not taken in by this suggestion, as they were aware that the government had earlier constituted a study

[25] Other members of the team were P.G. Mankad, who later became Finance Secretary; M. Narasimham, Secretary, Banking; V.K. Shunglu. See M. Narasimham, *From Reserve Bank to Finance Ministry and Beyond: Some Reminiscences*, p. 91.

group to examine the feasibility of an offshore centre but the idea had failed to catch on as it was mired in a number of problems.

By the mid-seventies, there was a gradual but discernible shift in the balance of forces within the Reserve Bank, with the traditional regulators in retreat. To be sure, the weight of tradition bore heavily on day-to-day operations and there was no deregulatory lead from the government. Nor was there any clear direction in the Bank's position except the knowledge that invisible receipts could, in time, become a valuable and reliable source of foreign earnings. The increase in the number of Indian nationals going abroad for employment, as reflected in the relaxation of P form clearance, from 30,000 in 1975 to 72,000 in 1976–77, was evidence enough to indicate that the tempo of such clearances had picked up. The shift towards liberalization, although halting and hesitant, was unmistakable and, in the event, irreversible.

From 1975–76 through 1978–79, the Indian economy was in fine fettle. Real growth averaged about 6 per cent, wholesale price inflation about 2 per cent per annum, and external reserves rose from Rs 1,021.9 crore at end-March 1975 to Rs 5,820.7 crore at end-March 1979. Described as the 'golden years' of the economy, they were a period of resource ease compared to the earlier years of perennial resource constraint. Favourable weather conditions and improved technology resulted in large increases in agricultural production and a build-up of large stocks of foodgrain supplies. The balance of payments moved into a surplus, mainly as a result of accelerated exports, a sharp upturn in migrant remittances and a progressive elimination of foodgrain imports. By all counts, India's adjustment effort following the first oil crisis was remarkably smooth and well-handled, resulting in a surplus on external accounts, creation of a large foodgrain reserve and promising growth prospects.

The changed balance of payments position from recurring deficits to a large surplus accompanied by a steady increase in reserves was not without its policy travails. The Reserve Bank and the Treasury were aware that a surge in foreign exchange receipts could rekindle inflation and they were concerned that rapid monetary expansion should not lead to a re-emergence of inflationary pressures. So, control of inflation became the main focus of short-term economic policy. Given the increase in reserve money resulting from the large external surplus, the RBI sought to control other sources of reserve money expansion and to restrain the growth of bank credit. Helped by the budgetary development and modest decline in public foodgrain stocks, the authorities were singularly successful, in the short run, in moderating the impact of reserve accumulation on money supply.

But the RBI continued to be concerned about the potential for inflation in 1977–78 and thereafter. Anxious to find the most effective and expeditious avenues of using the reserve resources to supplement domestic investment, towards the end of 1977, the Bank commissioned a study on 'The Utilization of India's Foreign Exchange Resources'.[26] The study highlighted the magnitude of the reserve expansionary thrust, and suggested that reserve ease and external assistance flows need to be deployed in productive investment, besides meeting the economy's current needs through net importation of goods and services. Conceding that available external resources could be used for acquiring non-productive assets like gold, it qualified its use only in times of inflation, and provided there was reason to believe that availability of gold will increase total savings and reduce hoarding of commodities. Conversion into less liquid and potentially more remunerative assets abroad was not ruled out, but qualified resort to this approach was suggested, only if there was a dearth of domestic investment opportunities. With foreign exchange reserves equivalent to nine months' imports in 1977–78, the Reserve Bank's analysis was that steps should be taken for a 'liberal and purposive' use of these resources, with a view to encouraging and strengthening the growth potential of the economy through the needed structural changes.

At the same time, the RBI warned that the comfortable foodgrain stocks position should not lull policy-makers into a sense of complacency and advised their productive deployment in developing the rural sector. Noting that a small beginning had been made with the introduction of the 'food-for-work' programme, the Bank urged the government to press ahead with expanding public distribution of foodgrains, thereby ensuring a minimum standard of consumption for the entire population and transforming the urban-based public distribution system to a broadbased one. The government was by and large receptive to the Bank's policy direction and this found a welcome echo in its *Economic Survey* for 1977–78, wherein it concluded that the policy emphasis will have to be on increasing the output of commodities, providing incentives for larger investment in industry, and formulating an overall strategy of growth that would utilize the increasing foreign exchange reserves. It underlined that 'the last was most important, if the paradoxical situation of a poor country lending abroad—which is what growth in foreign exchange reserves had amounted to—was to be corrected.'

[26] Board memorandum submitted by Executive Director A.K. Banerji on 12 December 1977.

In the context of the substantial increase in foreign exchange reserves, RBI Governor Patel recognized that the volume of work that had to be handled by the foreign section of the Department of Accounts had grown enormously over the last two years. Earlier, the bulk of the foreign exchange reserves were held in sterling treasury bills and dated securities. The management of the reserves did not, therefore, pose any major problem. But since 1975, the Bank had undertaken diversification of reserves into various currencies, and these were being invested to a large extent in the form of deposits with the BIS, with top-ranking banks abroad, and in dated securities issued by sovereign governments, the World Bank and the Asian Development Bank (ADB). Moreover, the 1979 amendments to the RBI Act expanded the horizon by broadening the scope for investment of the reserves in government-guaranteed securities, securities issued by other international institutions like the European Economic Community, European Coal and Steel Community and European Investment Bank, and also in certificates of deposit issued by top-class foreign banks.

Certain other provisions of the Reserve Bank of India Act, which appeared needlessly restrictive, were also amended. Hitherto, the Bank was permitted to place deposits only with a foreign bank in an overseas centre; it was debarred from placing deposits with any branch of an Indian bank functioning abroad. This invidious distinction was of little consequence when the extent of deposits with commercial banks abroad was negligible and the number of Indian banks having branches abroad was small. But in keeping with the country's interests as well as furtherance of the image of Indian bank branches operating abroad, the RBI, through an amendment to Section 17(13) of the Act, sought powers that would enable it to make available foreign currencies to scheduled banks, the IDBI, the IFCI and state financial corporations, for financing international trade and for import of capital goods, in the form of a rupee loan against which foreign exchange could be purchased from the Bank or directly as a foreign currency loan. In this way, more purposeful use was sought to be made of the growing reserves for fulfilling appropriate socio-economic objectives and promoting planned development.

Bearing in mind the growing complexity of foreign exchange regulations and the vast amount of work generated, the RBI Governor was keen to initiate action to simplify, rationalize and liberalize the operational aspects of the control. The Bank management recognized the need for assistance in two areas—for handling the investment portfolio of the foreign exchange reserves, and for a systematic simplification and codification of the foreign exchange regulations. Hitherto, changes had been made in the regulations on an ad hoc basis, but from then on, the Bank's management was keen to bring about changes that would make the foreign exchange regulations more streamlined and more responsive to the changing needs. Further, the need was felt for coordinated action and decisions, after consulting the Department of Economic Affairs, other Ministries of the government and the Enforcement Directorate.

The idea of employing a foreign consultant was toyed with, but considering the sensitive nature of the work involved, it was thought best to appoint local talent. After scouting around for a suitable candidate, the Reserve Bank chose J.S. Baijal, an IAS officer, who they felt had the background and experience. Designated as officer on special duty, Baijal was appointed on deputation for one year and was made directly responsible to the Governor. At the same time, to effectively cope with the increased and diversified workload, the foreign section of the Department was suitably restructured and its staff strength raised.

In 1976–77 the gross inflow of external assistance came down by 13 per cent as compared to the level of gross aid in 1975–76, due mainly to lower assistance from the oil producing countries and the virtual absence of grants under the UN Emergency Operations Scheme. It was but natural that donors responded to India's improved balance of payments position and growing self-sufficiency in foodgrains after 1975–76. Project aid commitments continued to rise, but disbursement and utilization of this aid was slow compared to other forms of aid. This was the time when, under McNamara's stewardship, the sectoral pattern of project lending of World Bank loans shifted towards rural and social development. On the external assistance front, the period also reflected a souring of relations between the World Bank and the US administration—the major lender to this multilateral institution. In the view of US Treasury officials, 'the World Bank was getting out of control'. The US administration was concerned that the rapid growth in lending which had resulted in massive undispersed commitments was mortgaging the World Bank's future borrowing capacity, and that the World Bank management was not responsive to donor criticism.[27]

The US Treasury also raised the sensitive issue of the bankability of the new rural and poverty projects but, ignoring the criticism, the World Bank went ahead with lending to countries that it considered creditworthy. Thus, India remained one of the largest borrowers from the World Bank with a large share of official debt outstanding. In the first half of the 1970s, India

[27] See D. Kapoor, John Lewis and Richard Webb, *The World Bank: Its First Half Century*, Vol. 2.

relied heavily on the World Bank and the IMF for its multilateral borrowing, while its neighbours—Pakistan, Sri Lanka and Nepal—remained customers of the Asian Development Bank. From this, it should not be inferred that India was a preferred customer of the World Bank, for disputes arose at a substantive level on the scope of bidding, shortlisting of foreign sources and choice of technology. These disputes had their roots in India's import substitution strategy and its strong desire to maximize utilization of domestic manufacturing capabilities.

The growth in foreign exchange reserves and the consequent easing of the foreign exchange situation provided an opportunity not only to clear India's outstanding purchases from the IMF on due dates, but also enabled India to undertake advance voluntary repurchases, be included in the IMF's designation plans and make payments for gold restitution.[28] By adopting a policy of prudent debt management, India set high standards in these matters and enhanced its creditworthiness in the eyes of the rest of the world. The country's exemplary record of meeting its IMF obligations on time stood it in good stead in later years. In matters pertaining to repurchases, the government relied heavily on the Reserve Bank for its advice. This was one of the most complicated aspects of Fund transactions and from time to time several modifications were made to the purchase and repurchase policies. Normally, the Executive Director gave broad indications on the currencies that could be utilized for a repurchase or a currency package that was available for purchase. But it was the RBI's responsibility to examine the feasibility of using that currency in the context of the exchange rates, the prevailing market conditions, etc., and, by and large, the Bank's viewpoint prevailed.

It will be recalled that since the 1950s import control had been used as a rigid instrument to regulate aggregate supply and to protect international reserves. The year 1976–77 saw the beginning of a slow process of import liberalization. The import policy was gradually relaxed and greater automaticity was introduced in the features relating to imports of raw materials and components for domestic production. With the substantial expansion in non-traditional exports and improvement in the balance of payments, the authorities felt that a basic policy review was needed. The Alexander

[28] In 1976–77, transactions with the IMF comprised repurchases of Rs 303 crore (representing the CFF drawing, the 1974 oil facility and a part of the first credit tranche), Rs 21 crore against SDRs under designations and Rs 7 crore towards gold restitution). In 1977–78, payments totalling Rs 293 crore were made to the Fund (Rs 249 crore towards repurchase of gold and credit tranche drawings, Rs 7 crore on account of gold restitution and Rs 37 crore against SDRs accepted against designations).

Committee was set up in 1977 to review the import and export policies, suggest improvements in the structure and use of trade policy instruments, and propose measures to rationalize and streamline procedures. The Committee, in the course of its work, called on the then Governor of RBI, I.G. Patel. In the Bank's perception the licensing system was a temporary expedient and the conditions of the mid-seventies were appropriate for its relaxation. It therefore welcomed the Alexander Committee's recommendations, the basic orientation of which was to increase industry's exposure to the winds of international competition and stress the need for productive efficiency. Many of its recommendations constituted the basis for the annual import/export programmes since 1978.

The most important change in import policy was introduced in 1978–79, when all items not specifically restricted or banned were listed under the open general licence (OGL) category and could be freely imported for domestic production.[29] The decision was a heroic step forward for a government that remained fundamentally apprehensive of foreign competition. But official nervousness about the wisdom of the move continued and played a part in reversing some of the OGL items back to the restricted and banned list, at the first hint in 1980–81 of less favourable external payments prospects.

In 1977, following the overthrow of the Congress government, the Janata Party came to power. As with any change of government, there was a shuffle in the bureaucracy and I.G. Patel was nominated as the new Governor of the Reserve Bank. Among the ill-conceived policies that Patel was pressurized to implement was the sale of gold officially to discourage smuggling. The Janata government needed a radical crutch to show that it was discarding old baggage and was prepared to experiment with market measures. The Governor tried his utmost to dissuade Finance Secretary H.M. Patel from adopting this course as he was convinced that the measure would have little or no impact on countering smuggling. But the Finance Minister was not ready to oblige, as he was under political pressure to implement the scheme. From the outset, the Governor indicated the impracticality of the measure, for it required import of gold in large quantities. For a credible market intervention a much larger stock of foreign exchange was required to buy gold in the international markets. The Governor saw the futility of using the limited reserves of foreign exchange for this purpose but was unable to fend off the pressure. As a compromise, he suggested

[29] The new system was based on a negative list, in contrast to the earlier positive lists, and all raw materials and components not specified in the list could be imported under OGL.

that the Reserve Bank would undertake the operation of selling gold only as an agent of the government, and that it would use confiscated gold, newly mined gold and 'non-returnable gold' acquired through the gold bond scheme, and refrain from using official foreign exchange reserves. The budget of 28 February 1978 gave executive authority to the Bank to hold gold auctions. The auctions were perhaps inspired by the gold auctions on behalf of the trust fund by the IMF between June and August 1977, but the greater likelihood was that the decision was triggered and catalysed by the large uncovered budgetary gap of Rs 1,050 crore.[30]

In retrospect, it can be said that the gold auctions were, at best, a damage control exercise, for the Reserve Bank had grasped the nettle and trimmed the operation to make it virtually harmless. About the Bank's official hierarchy responsible for implementing the measure, the least that can be said is that the auctions were conducted efficiently and with probity. It involved taking some sensitive decisions, such as how to conduct the auctions fairly and objectively, how to make them leakproof, and how to avoid corruption and favouritism. Considerable care had to be exercised to ensure there was no cornering of the supplies while obtaining as high a price as possible. Senior Deputy Governor M. Ramakrishnayya, who was in charge, exercised close surveillance over the operation. In all, fourteen auctions were held from 3 May to 23 October 1978, in which 12.95 tonnes of gold were sold to the public, yielding a revenue of Rs 86.96 crore.

The Janata government, which initiated the gold auctions, failed to survive for long and the Congress party was soon back in power. The Congress, in its quest for skeletons in the Janata cupboard, appointed a one-man enquiry committee headed by R.K. Puri, a former Governor of the Reserve Bank, to substantiate claims that the gold had been cornered by a few parties. The report of the one-man-committee was as controversial as the auctions. Deputy Governor Ramakrishnayya, who had headed the Gold Sales Policy Committee and conducted the auctions, had this to say: 'He (Puri) gave me the impression of a man who had made up his mind even at the start and was only searching for evidence to confirm that gold was cornered by a few parties and that Dr I.G. Patel and I in the Reserve Bank had facilitated the process.'[31] The conclusions of the report were along expected lines. One of Puri's observations was that the Bank should have insisted on

[30] Para 109 of the budget speech justified the measure by stating that it is justifiable, in our present circumstances, to utilize a part of our accumulated gold to reduce the expansionary effect of budgetary transactions.

[31] Ramakrishnayya, *Two Administrators: Interaction between ICS and IAS*, p. 105.

a formal contract before undertaking the agency function. As Ramakrishnayya has recorded, Puri's remarks on the reserve price of gold were contrived. Although the Bank took a dim view of the findings of the Puri enquiry, the ironical fact was that both Patel and Ramakrishnayya had to submit themselves to it. All said and done, Puri could find nothing objectionable. As Patel recounted in his memoirs: 'In fairness to him I must say that in questioning me and my officers, he was scrupulously courteous and professional and not confrontational at all'—his conduct of the enquiry was irreproachable as far as the Bank was concerned (see I.G. Patel, *Glimpses of Economic Policy: An Insider's View*, p. 160). However, the episode was a sad reflection on a political system that sought to sully the reputation and honour of officers who endeavoured to execute policies faithfully and honestly and to the best of their abilities, irrespective of the party in power. The findings of the enquiry report along with comments by Ramakrishnayya were placed before a Cabinet Committee who eventually decided not to pursue the matter; thus the Puri enquiry report on the controversial gold auctions was consigned to the archives.

The payments situation changed dramatically in 1979–80 as many of the favourable aspects of the previous four years were reversed. Agricultural growth suffered a turnaround following failure of the monsoon, and industrial bottlenecks emerged owing to shortages of power, coal and cement, a deterioration in labour relations, and difficulties with port congestion and railway transportation. Infrastructural inadequacies bedevilled the economy, industrial production in particular. These inadequacies were accentuated as the poor rainfall affected hydel power generation, while the reduced coal output, as also lower turnaround of wagons from coal pitheads to power houses, resulted in a fall in thermal power generation. While the supply position weakened, demand continued unabated, owing, in part, to the effects of fiscal operations, which continued to be expansionary, and to the high degree of liquidity in the economy at the beginning of the year. Inflation soared from 3 per cent in 1978–79 to 22 per cent in 1979–80. In addition, the external terms of trade worsened significantly owing to higher prices for imported petroleum and fertilizers. The full impact of the increase in oil prices was reflected in the trade deficit, which zoomed from Rs 2,200 crore in 1978–79 to Rs 3,400 crore in 1979–80 and further to Rs 6,200 crore in 1980–81.

The emergence of inflationary pressures and the weakening of the balance of trade in 1979–80 were largely attributable to inadequate domestic supplies. The more important supply problems occurred in the industrial and services sectors, where shortages in critical industries created serious inter-industry imbalances. There was also the necessity to import foodgrains at a time when Indian exports were affected both by international recessionary conditions due to growing protectionism abroad and a weakening of export prices. To meet the short-term cyclical imbalance, India drew SDR 266 million under the compensatory financing facility (CFF), but, even so, by late 1981, the country's international reserves had slid down to about three-and-a-half months imports. In the Reserve Bank's *Annual Report* assessment for 1980–81, the conclusion categorically stated that the answer to the balance of payments difficulties lay not in curtailing imports and reducing economic growth, but in substantial and sustained efforts to promote export growth. It was equally necessary to explore commercial and other forms of external finance, even if more expensive to service, if enduring changes were to be brought about in the structure of production, which alone would ensure a stable balance of payments adjustment. Recognizing the uncertainty attached to other forms of external financing, the Bank urged for a process of adjustment that would be as speedy as possible, as also within a positive framework, to make it enduring. This obviously called for discipline in all areas of the economy, particularly in the fiscal and monetary environment. An important facet of this requirement, as the Bank saw it, was judicious containment of further additions to the present high level of liquidity in the economy. The circumstances demanded 'an apposite combination of fiscal and monetary policies buttressing improvements of a real nature pertaining to technology and organization'. In short, a comprehensive approach was advocated in which supply and demand management were seen not as alternatives but as integral parts of a long-term strategy.

That was the time when the formulation of the Sixth Five Year Plan was under way, and it was decided to weave into the Plan an adjustment strategy to rectify the structural imbalance, by accelerating the effort for import substitution of items like petroleum, fertilizers, steel and cement, and strengthening the infrastructural base of the economy.

TWISTS AND TURNS OF EFF LOAN NEGOTIATIONS

The September 1980 biennial election saw the appointment of Narasimham as the Indian Executive Director to the IMF Board. Narasimham pursued the idea of approaching the Fund for a medium-term loan under the newly established extended fund facility (EFF). In fact, even before moving to the Fund, while still an Executive Director at the World Bank, Narasimham had felt that with the second round of oil price increase and dim prospects for the creation of a new oil facility, India's economic problems would be of a different complexion, requiring heavy investment in oil and related areas. He began by sounding out his colleagues at the IMF on how the Fund management would react if India was to approach the Fund for a medium-term drawing to cushion the structural impact of the oil price increase. Emboldened by the positive feedback received from them, his next move was to convince the Indian Finance Minister Venkataraman to consider such a drawing. But Venkataraman was not enamoured of the idea, nor was the Economic Affairs Secretary, R.N. Malhotra. Narasimham, during a customary courtesy call on Prime Minister Indira Gandhi, broached the topic with her by referring to the deteriorating external payments position owing to the oil price increase, and the impact it would have on measures taken to liberalize imports and deregulate industry. He suggested that it would be appropriate to seek IMF assistance early on in the game, before a long queue of countries emerged, and to do so from a position of strength rather than allow the external payments situation to deteriorate before approaching the Fund. He argued that approaching the Fund early would make a great deal of sense for it would mean getting funds with milder conditionalites.

Seeing that there was a distinct gain in adopting such a course, the Prime Minister instructed Narasimham to flesh out his proposal and leave a note with her Secretary. A few months later, the government decided to formally nominate Narasimham to the Executive Director's post at the IMF. On assuming office, he was instructed by none other than Finance Minister Venkataraman to pursue the matter of an EFF loan from the Fund. This, then, explains the transfer of Narasimham from the World Bank Board to the Fund Board—a move that dismayed the World Bank chief Robert McNamara, who highly valued Narasimham's contribution to the World Bank Board. This is what McNamara had to say of Narasimham:

> Your dedication, your consistently thoughtful and informed views, your careful judgement, your breadth of vision and your dogged hard work have all combined to set a standard of service on the Board that deserves the gratitude, not only of India and your other constituencies but of the entire development community itself.[32]

[32] Robert S. McNamara's letter dated 28 October 1980 to M. Narasimham in *From Reserve Bank to Finance Ministry and Beyond: Some Reminiscences*, p. 131.

On assuming office at the IMF, Narasimham set the ball rolling for an EFF drawing, which was to be the largest loan to any country in the history of the Fund. Aware of the Fund's philosophy and preference for an early approach and not when a member became an emergency case, the Executive Director was confident of securing finance with the mildest of conditionalities and without measures destructive of national prosperity. The thrust of his argument was that the Fund programme represented an alternative to deflationary adjustment for India, unlike crisis cases that called for deflationary adjustment. The formal approach for Fund assistance was made in 1980. Initially the negotiations proceeded very smoothly, with both the IMF staff and the Managing Director, Jacques de Larosiere, being most receptive to the Indian request. In the course of his meetings with the Managing Director, Narasimham pointed to the sudden and severe deterioration in the payments position resulting from the oil price increase and the irreversible shift in the terms of trade. He reminded the Managing Director that India was a disciplined borrower who had prepaid its drawings from the Fund, and had even contributed to the resources of the Fund by agreeing to be included in the designation plan in periods when its external payments position was comfortable. He argued that vision and bold confrontation of its needs had prompted India to approach the Fund in anticipation of the pressure developing on the external payments front. The Indian authorities, Narasimham added, recognized that the solution lay in a major overhaul of the public sector investment programme aimed at increasing its efficiency.[33] The support that the Fund drawing would provide to the exchange reserves, Narasimham pointed out, would enable continuation of the import liberalization process that India had embarked upon.

Later, in discussions with the IMF staff, Narasimham gained the impression that the Fund management would not be averse to a drawing by India in the region of SDR 5 billion—a figure certainly larger than the SDR 3 billion earlier indicated to the Finance Minister and Prime Minister. Thus the negotiations got off to a happy start with the Asian Department fully cooperating with the Executive Director's office in expeditiously processing the request. When the request document, with a background paper on the developments in the Indian economy, was circulated for comments to other departments of the Fund, the first critical rumblings became evident. The Exchange and Trade Restrictions Department of the IMF and Ernest Stern, Vice President of the World Bank, queried the need for such a large

[33] See Joshi and Little, *India: Macroeconomics and Political Economy, 1964–91*, Oxford University Press, New Delhi, 1994, pp 58–62.

drawing and were critical of the mild conditionalities attached to the drawing. Defending the Indian stance, Narasimham argued that while it was true that the conditionalities agreed upon in the first instance were by no means harsh, all that was sought was to improve India's budgetary position, which no one could deny was necessary. For the first time in 1980, the budgetary position had revealed a revenue deficit and this was politically unacceptable to all parties in India. The only other conditionality related to the adjustment effort to reduce the current account deficit, estimated at over 2 per cent of GDP, which was wholly accounted for by the rise in the oil import bill and deterioration in the terms of trade, which was then estimated to cost SDR 9 billion. The logical requirement for this was exploitation of the Bombay High oil reserves in the medium term. There was little that was objectionable in these terms to Mrs Gandhi, despite the fact that she was then the chairperson of the Non-Aligned Movement, which was opposed to IMF conditionality.

There is some evidence to show that the Managing Director, De Larosiere, was initially satisfied with the adjustment programme negotiated by the Fund team. At the Tide Water meeting in Kuwait, he conveyed his satisfaction to Governor Patel and said that he would deliver as long as the budget for 1981–82 remained on course as per the agreement.[34] The first sparks of opposition to such a large drawing began to fly at the 1981 Interim Committee meeting in Gabon, in mid-May 1981, when the Managing Director who was hitherto supportive, went on the defensive. At the customary meeting between the Finance Minister and the Indian delegation, and the Managing Director of the Fund, the latter, obviously under pressure from the US, backtracked and hesitatingly suggested that India could consider going in for a stand-by rather than an EFF loan. To the Finance Minister, there was little justification for even suggesting such a course, and he flatly refused to consider the stand-by option. He made it perfectly plain to the Managing Director that India would go for the EFF or nothing. After all the motivation for the creation of the EFF was to help members tackle medium-term issues arising from supply-side imbalances. The Indian side forcefully argued that it was not a case demand-side management policies, it was an open-and-shut case of supply-side adjustment initiatives. Seeing that the stand-by option was vigorously ruled out, the Managing Director vaguely hinted that he had to take the Board along with him and explained that he was anxious to see that such a large drawing was favourably received by the Board, for, failure to receive the requisite support would

[34] I.G. Patel, *Glimpses of India's Economic Policy: An Insider's View*, p. 168.

tarnish the image of a large developing country like India. The Indian delegation refused to be browbeaten into acceptance of a stand-by arrangement, which would mean being on a short leash with conditionality strings attached; the Managing Director then decided to leave the door open for further discussions.

It would not be amiss to say a word here about the behind-the-scenes moves that were apparently on, to persuade the Managing Director to reconsider the Indian request. There had been a change in the political leadership of the US and President Reagan, who was at the helm of affairs, generally pushed for a tougher stand by the IMF and World Bank Boards. The Fund's largest shareholder, the US, was unwilling to support India's request and was amazed that India could dare to lay claim on IMF resources of such magnitude. US banks were apparently badgering the new US administration that they could meet the legitimate needs of all countries, both rich and poor, and that India should be forced to meet its requirements for financial resources through commercial borrowing. One of the most vocal critics of the Indian request was Charles Wriston of Citibank, who launched an attack on the proposed drawing by India.[35] But, unlike many of the other developing countries, India had wisely eschewed the path of commercial borrowing and was reluctant to traverse that route. India valued its impeccable debt servicing record and refused to get ensnarled in a debt trap. The foreign commercial banks saw India as a low-risk sovereign borrower and were angling to bring it into their borrowing net; they accused the IMF of crowding out the private banks. The US, thus, adopted tactics to push India into the foreign commercial bank arena, which the Indian authorities resisted.

Curiously, the EFF loan, which was unique in several respects, met with strong criticism and resistance even in home territory. In mid-October 1981, N. Ram, correspondent of *The Hindu*, laid his hands on the letter of intent from the Indian Finance Minister and the memorandum submitted to the IMF in support of its request. In one of his despatches from Washington, on 15 October 1981, he frontpaged a news item about the loan request, giving details of the state of the discussions and reproducing verbatim the draft contents of the letter of intent. The leak proved most embarrassing for the government as, based on Ram's report, a rabid attack was launched by Ashok Mitra, Finance Minister of West Bengal. In a White Paper entitled 'The IMF Loan: Facts and Issues', he appealed to the Parliament and the public to abrogate the loan arrangement. The attack was inspired by

[35] See I.G. Patel, *Glimpses of Indian Economic Policy: An Insider's View*, p. 168.

the 1966 experience of devaluation and the loan was viewed as a loss of economic sovereignty. Ashok Mitra went so far as to commission articles by a group of leading economists, to marshall arguments against the loan and to derail the arrangement. The whole issue assumed political colour when twenty-three chosen economists, at the invitation of the West Bengal government, met in Calcutta in August 1981 and issued a joint statement denouncing the government's approach to the IMF for assistance. The loan thus became the focus of a controversy both at home and abroad.

At home, the government and the opposition were at loggerheads on the loan issue. The opposition's demand was that the Parliament and the people should have an opportunity to examine the conditionalities included in the deal. Ashok Mitra was insistent that the centre disclose the terms on which it was trying to obtain a loan from the IMF. In response, the Finance Minister assured the Lok Sabha that in its current negotiations with the IMF, the government would not do anything 'derogatory to the country's self-respect or to the nation's interest'. While the conditions for the IMF loan could not be disclosed, as it was at the negotiation stage, the Finance Minister assured the House that the Ordinance banning strikes in essential services was not a condition for securing the loan. Denying that the Ordinance was at the behest of the IMF and that the hike in prices of petroleum products was at the prodding of the RBI, Venkataraman asserted that these measures were taken keeping in mind the national interest. But the opposition continued its tirade against the government. George Fernandes demanded that the government should not be allowed to mortgage the country, to which Venkataraman quipped, 'Mr Fernandes should know I have no authority to mortgage the country.'

Following the leak in *The Hindu*, Narasimham rushed back to India to assist the government in defending the loan. Prior to leaving Washington, the Indian Executive Director lodged a strong protest against the failure of the Fund's security system and the Managing Director ordered an investigation into the leak. Dale, the Deputy Managing Director, described the leak as 'quite possibly the most serious and damaging in the history of the Fund'. But despite the Fund management's best intentions, nothing much came out of the investigations, as the reporter claimed that he had obtained a copy of the letter of intent from an Executive Director.

In the meanwhile, the US focus shifted to preventing the loan from materializing. During the absence of the Indian Executive Director from the headquarters, the US Executive Director, Dick Erb, after prolonged interaction with his Treasury counterpart on the Indian loan request, called on the Advisor, C.J. Batliwalla, at the Indian Executive Director's office late one evening, to convey the message that his authorities would find it extremely difficult to support the Indian request for an EFF loan in its present form. The adjustment programme, in the words of the US Executive Director, lacked specificity, the balance of payments need was not clearly established and the large investment programme was sought to be financed exclusively by recourse to Fund resources. In the reading of the US administration, it was a development-type loan that would qualify either for World Bank assistance or finance from the international credit and capital market. There was also a hint in the US stand that the exchange rate was not in line and needed adjustment to reflect the true competitive situation. But the actual trigger for the US criticism was political and rather sensitive to be openly mentioned—the fact that India had placed a large order for purchase of the Mirage aircraft.[36] The substance of the US Executive Director's remarks were relayed by the advisor to the Finance Secretary, with a copy marked to the Governor of RBI and the Indian Executive Director, Narasimham.

Developments both on the home front and abroad did not augur well for smooth passage of the loan. The Indian government realized that with formal negotiations under way, an all-out effort would have to be made to seek the support of all the Fund members. In the months following Gabon, Indian officials were virtually on the road, lobbying with foreign governments and top echelons of the international banking system for support. De Larosiere, Managing Director of the IMF, was urged to preserve the independence of the Fund. The Managing Director not only stood his ground in supporting the Indian request but persuaded the French government also to support the request. In the meanwhile, during a visit to Washington, Governor Patel called on Paul Volcker, who was chairman of the US Federal Reserve, and explained to him that India's needs were large, and that the Fund drawing would provide the necessary leverage to borrow even more from private banks and the mixture of concessional and market-related borrowing would make the financial package more manageable. In the absence of a Fund drawing, India would be compelled to borrow less and compress its demand for imports, as expensive borrowing would be unmanageable. Volcker saw the logic in Patel's argumentation; however, he was unable to soften the attitude of Tony Solomon of the New York Federal Reserve and nothing much came out of that initiative.[37] Patel

[36] The IMF *Morning News* carried a news item titled 'India had placed a large order for the purchase of Mirage aircraft from France'. Source: *Le Monde*, the French daily.

[37] See I.G. Patel, *Glimpses of Indian Economic Policy: An Insider's View*, p. 169.

also called on Geoffrey Howe, the UK's Chancellor of the Exchequer, and several influential bureaucrats in the German Finance Ministry, and lobbied hard for their support. At the same time Narasimham, the Indian Executive Director, met every other Executive Director at the Fund, and explained to them the background against which India was approaching the IMF. These were more in the mode of an informal exchange of information prompted by a desire on the Indian side to assess the degree of support that would be forthcoming.

Turning to the specifics of the negotiations, the first two IMF negotiating missions came to Delhi in January and April 1981, under the leadership of Tun Thin, Director of the Asian Department. The structural nature of the payments problem necessitated a review of investment priorities to improve and place on a sustainable basis, the external sector. The Fund team, with inputs from World Bank staff, reviewed the developments and investment priorities, and the initiatives taken by the authorities to move the economy on to a path of stabilization and growth. There was no denying on either side that production and distribution bottlenecks and bureaucratic rigidities were acting as constraints on the economy and preventing it from achieving its potential. Hitherto the policy had been one of furthering import substitution in tradeables but the oil price increase had introduced a new dimension into the reordering of investment priorities.

There was also some discussion on the quantum of the loan. Based on the access limits then in force, India could draw up to SDR 7.7 billion from the Fund over a three-year period (equivalent to 450 per cent of its quota). Of that amount, up to SDR 2.4 billion would be from the Fund's own resources and the remainder from borrowed funds. The Indian authorities were initially inclined to confine their request to the portion available from the Fund's own resources, but the Fund mission's assessment was that with a bleak medium-term balance of payments outlook, a stronger and larger adjustment programme was warranted, and India would qualify for a larger drawing. Following discussions, an amount of SDR 5 billion was agreed upon, which, at that point of time, represented the largest commitment for the use of Fund resources.[38] At that point in the negotiations, several key performance criteria relating to monetary, fiscal, external borrowing and liberalization measures had not been firmed up. Before these could be settled, the news leak in *The Hindu* complicated the sensitive negotiations.

From the beginning, the Indian authorities were prepared to undertake

[38] This record was held by India till February 1995, when Mexico availed of a drawing of SDR 12.1 billion, making that the largest.

adjustment through appropriate stabilization and liberalization measures. But they were keen to proceed at their own pace and in their own way, and not to be seen as toeing the Fund line. The adjustment strategy had to bear a 'swadeshi' (nationalist) tag and be seen by the public as a homegrown product. It was sought to be achieved through self-reliance in energy, especially in the exploration and development of hydrocarbons. Accordingly, high priority was given to the objective of achieving a dynamic export growth, a sizeable step-up in infrastructural investment and higher domestic savings.

On the monetary and credit front, the Reserve Bank recognized there was an uncertain 'import element' in the form of frequent revisions in international crude prices, which imparted an inflationary impulse and widened the already large deficit in external trade. Though the liquidity effect of possible expansion in overall domestic credit was significantly offset by the decline in foreign currency assets, in the RBI's reading, given the continuing inflationary situation, it would be necessary to ensure that credit expansion was essentially for productive purposes. As early as March 1980, the Bank announced credit guidelines to banks that were indicative of a continuing concern about inflation and a need 'to continue the strict regime of credit discipline'. Over 1980–81, a highly restrictive monetary and credit policy stance was maintained with the intention of producing an overall tightening of liquidity. At the same time, the Bank maintained a balancing act, for it recognized that, while it was necessary to set a tone of stringent restraint, certain segments, notably exports, needed continued and selective refinance.

The Governor, with his team of advisors, personally monitored, on a weekly basis, the monetary and credit trends. Although the March 1981 credit policy urged a slowdown in the pace of monetary expansion, it was timid and rather accommodative: no specific ceilings were indicated. By end-May, it was evident that slowing down of the pace of monetary expansion had not occurred and that the growth of primary money in 1980–81 had been large. The RBI Governor, on his return from the IMF May 1981 meeting in Gabon and aware of India's request for an EFF drawing, recognized that there was already a potential for a large monetary expansion in 1981–82 and that, as a basic policy objective, a slower pace of monetary expansion was an ineluctable necessity. Accordingly, in the 27 May 1981 slack season credit policy, the cash reserve ratio (CRR) was raised from 6 to 7 per cent of demand and time liabilities, to be effected in two phases. At the same time, a sharp hike was effected in the refinance rates, with the rate on rediscounting of bills and discretionary refinance raised from 11 to 14 per cent; the first tranche discretionary refinance was at 14 per cent, while subsequent tranches, if any, attracted higher rates of interest.

Close on the heels of the May 1981 measures, on 11 July 1981, when the Governor, in the course of his weekly monitoring of credit developments, perceived that there was no abatement in the pace of monetary and credit expansion, a package of measures was slapped on to contain the inflationary pressures. The Bank rate was raised from 9 to 10 per cent and the statutory liquidity ratio (SLR) from 34 to 35 per cent of total demand and time liabilities, to be reached in two phases; the phased increase in CRR was also advanced. In the area of selective controls, the minimum margins against stocks of wheat, paddy/rice were raised by 10 percentage points across the board. Although the Indian authorities had not yet formally committed to the ceilings for monetary expansion with the IMF, the Governor recognized that the process of adjustment would have to be speedy and enduring. This obviously called for discipline in all areas of the economy—not just higher production to meet domestic requirements and fully exploit export opportunities, but also a rise in productivity and a fiscal and monetary environment that maintained and enhanced the competitiveness of Indian products in international markets. Judicious containment of further additions of liquidity to the existing high level was seen by the RBI Governor as an important ingredient of the adjustment exercise.

Restrictive measures in the early part of the financial year notwithstanding, the trend in credit expansion was clearly out of alignment with the RBI's guidelines to banks in respect of permissible ceilings. This followed principally from a sharp rise in deposits in contradiction to the normal pattern of deposit growth. It also reflected the unusually large drawals on available cash credit limits in anticipation of further tightening of their use. Non-food credit expansion, which was Rs 467 crore at mid-July, widened to Rs 962 crore by end-October 1981. The continuance of the credit boom was clearly inconsistent with the objective of reducing monetary expansion and, consequently, inflationary pressures. Further tightening therefore became inevitable, to reduce the signs of overheating and to dampen the expansionary pressures emanating from the primary liquidity in the system. It was obvious that the July measures did not have a sufficiently strong impact on the surging demand for credit. RBI's concern was that if the total ceiling was exceeded but the sub-ceiling on credit to the government was within the limit, the onus of failure would be on the Bank.

Governor Patel convened a series of meetings, from September 1981, of senior officers associated with credit policy. They expressed divergent views. Some officials argued that the July measures could suffice while others argued for strong measures. Some officials felt that, in the face of the busy season demand for credit, a full percentage point increase in CRR would turn out to be savagely restrictive. The Governor, however, felt that the May/July measures were inadequate and decided in favour of a full percentage point hike in the CRR, from 7 to 8 per cent, to be implemented in four stages. This October 1981 measure was lethal but pre-emptive action was resorted to, knowing that the first IMF ceiling would have to be met in November 1981 and the second by February 1982. In retrospect, it can be said that this move had the desired effect. The disproportionately large credit expansion witnessed in the first half of 1981–82 fed by a high pace of deposit growth was followed by a marked slowdown in the second half of the year. The fall in deposits caused an unprecedented resource constraint and a large number of banks defaulted in the maintenance of CRR and SLR. Several banks resorted to across-the-board cuts in limits, while some banks restricted further drawals on limits already sanctioned. A resource stringency coincided with the busy season. Once it was clear that the February 1982 ceiling had been met, the last phase of the CRR, which was to be effective from 26 February 1982, was initially deferred and later rescinded.

The difference of perception within the RBI on the appropriateness of the October 1981 credit policy measures surfaced again in discussions in early 1982 with the IMF, when Kadam, the Principal Economic Adviser, described the October 1981 move as a 'panic reaction'. What the above developments show is that even before concluding the EFF loan, the Indian authorities recognized the need for undertaking voluntary adjustment measures, and, between 1980 and 1981, a series of difficult decisions—in the areas of administered prices, industrial policy, export and import policies, credit and monetary policies, were voluntarily taken with no strings attached. At the same time, emphasis was placed on building up capacity in core areas like steel, fertilizers and cement, and growth targets in these sectors were woven into the canvas of the Sixth Plan.

It was against the backdrop of these developments and policy intentions of the government that the Indian authorities forwarded their request for an EFF loan. The focal point of the adjustment effort was reduction of the current account deficit, which, in 1981, was estimated at over 2 per cent of the GDP. The deficit translated itself into an annual figure of over SDR 3 billion. This was sought to be reduced gradually over three-year period to a level that would be taken care of by normal capital inflows. The balance of payments outlook for 1981–82 incorporated an expected fall of 11 per cent in the oil import bill. Domestic crude oil production was slated to increase by 65 per cent following the settlement of disturbances in the northeastern region which had severely disrupted oil production in 1980–81, and substantial additions to productive capacity from new offshore oilfields. The emphasis on investment in the import substitution sectors had the endorsement of the World Bank, both in physical and financial terms.

The demand management aspects of the programme related to a prescription of ceilings on domestic credit expansion, with sub-ceilings on credit to the government. Around the time that India approached the Fund in early 1981, the level of fiscal deficit was between 6 to 7 per cent of GDP, which, in the perception of the authorities was manageable. In the course of the negotiations, the Fund staff suggested pruning the ratios but, except for modest adjustments in the ceiling levels, no major or drastic reduction was insisted upon. This was because the Indian negotiators ably argued that the bulk of the investment was needed to effect structural adjustment in the public sector, and that excessive compression of the deficit could prove counter-productive to the objectives of the structural adjustment effort. Besides, the Indian authorities were alive to the danger of excessive reliance on Reserve Bank credit and had taken steps to augment domestic resource mobilization.

The issue of ceilings, however, was not easily settled. During negotiations in Delhi, the size of Bank-financed deficit remained a sticky point between the IMF staff team and the Indian negotiators, with the latter pushing for a higher figure. The Prime Minister was informed that the Fund was acting difficult, so she sent for Executive Director Narasimham to discuss the issue. Narasimham explained to the Prime Minister that the Indian side had pitched for higher ceilings as a negotiating tactic, knowing that the Fund would seek to reduce them. Since they were close to agreement on a figure, he implored the Prime Minister to accept the figure, for, in his judgement, anything higher would not be in the overall interest of the economy. The Prime Minister was convinced and the Indian side agreed to the domestic credit ceilings and sub-ceiling indicated by the IMF team.

The other quantitative performance criteria incorporated into the programme related to the ceiling on external commercial borrowings, which posed no problem for the Indian side, for India had always adopted a policy of judicious restraint in respect of external borrowing. The qualitative criteria were with regard to import policy and exchange restrictions. Since, from 1978–79, India had embarked on a policy of gradual liberalization, the authorities themselves were in no mood to reverse their stance as the intended policy was to provide more liberal access to imported inputs. As regards the exchange rate, there was absolutely no pressure whatsoever from the Fund for any adjustment; the Fund's reading was that the exchange rate policy was consistent with the declared objective of pursuing policies designed to strengthen the balance of payments. The IMF staff appraisal made no reference to the exchange rate, while the main report accompanying the request had this to say:

> They (meaning the Indian authorities) recognize the crucial role of exchange rate policy in ensuring adequate profitability of the export sector. While the authorities do not believe that a discrete change in nominal exchange rate is necessary at the present time, they intend to keep exchange rate policy under review and to make adjustments when appropriate to encourage exports and promote external adjustment.[39]

Although the negotiations dragged on for a whole year and were at times difficult, they were at all times cordial and without rancour. As indicated in the content of the programme, the conditionality was not overly rigorous, for the management of the Fund 'felt that the nature of the programme was appropriate' and the Fund would be playing a catalytic role as well as providing direct financing.[40] The structural policies described in the arrangement were not specific performance criteria but, rather, commitments by the government that were to be reviewed from time to time over the period of the arrangement. This was not unusual, yet it invited considerable criticism that the Fund would have little control over the main elements of the structural adjustment programme. But then, the financing element was backloaded and made dependent on the progress of the adjustment effort, and for this reason the full schedule was not included in the staff report.

The Fund Board met on 9 November 1981 to consider the Indian request. The discussion lasted the entire day with every member of the Board intervening in the debate. Overall, the tenor of the discussion was supportive and appreciative of the adjustment measures undertaken by the Indian authorities. This, however, did not mean that it was free from critical overtones. Anticipating the likely comments, the Indian Executive Director, in his eight-page introductory remarks, carefully provided all the argumentation to defend the request. He concluded his opening statement by venturing to state that 'the strength of the adjustment effort is worthy of the size of the loan', adding that 'where the need is demonstrable and effort at

[39] EBS 81/198, 7 October, India—Use of Fund Resources—Extended Fund Facility.
[40] *Silent Revolution—The International Monetary Fund 1979–1989*, pp. 709–15.

adjustment convincing, the size of the loan, important as it undoubtedly is, should, I believe, not be a constraining factor.'

During the debate, fulsome support came from the developing country Directors, particularly the Indonesian and Brazilian chairs. The Indonesian Director had this to say:

> From a qualitative standpoint, the direction taken by the programme was highly commendable. It provided for the cautious control of liquidity, the removal of regulations impeding the process of growth, the reduction of price controls and subsidies, the development of new sources of energy, the enhancement of agriculture, the mobilization of domestic savings and an increase in investment to make both import substitution and export promotion possible.

The measures thus introduced would provide a better balance between demand and supply. He indicated that his constituency would warmly support the request and that he was not worried about the so-called large amount. Likewise, the Brazilian Director gave warm support and demolished the argument that it was not a balance of payments loan but development assistance, by saying, 'all development finance was also balance of payments support, just as all balance of payments support was inevitably also support for development'. He added that the Indian programme was well-conceived and merited the Fund's full support.

The developed countries, other than the USA, while extending support, had reservations on some aspects of the adjustment strategy. France was positive and categorized the arrangement with India to be in accordance with the Fund's policy of requiring positive conditionality; it commended the Indian authorities for their early approach to the Fund and the scale of the adjustment measures already implemented or contemplated. The US Executive Director, Richard Erb, abstained, on the grounds that he was concerned about the need for as much money as India had requested, for he was convinced India could meet its financing needs through commercial bank borrowing. Despite attempts to persuade the G-5 against the Indian request, finding that it was isolated, the US desisted from casting a negative vote but abstained. Erb's intervention, though critical, did contain isolated remarks on the strong and positive nature of the effort. The criticism was along familiar lines: genuineness of need, mix of external resources, revolving character of the use of Fund resources and whether the Fund was getting into investment financing. Adequate and convincing answers to these were already provided in the Executive Director's opening remarks and, with equal force and conviction, reiterated in his concluding observations.

The German chair was also concerned about the size of the arrangement and its potential impact on the Fund's liquidity. His authorities had examined the request, he said, with great care and concern and considered all the risks and uncertainties inherent in the adjustment programme; and they were finally in favour of supporting the request, although they felt that the intentions were somewhat vague, leaving a measure of discretion that might be too large to receive Fund support for the size of loan proposed. Misgivings along similar lines were expressed by the Australian chair. The IMF staff, however, defended the request ably by stating that the Indian case was in line with all the requirements of the 1974 EFF decision—viz. with the alternative approach of successive stand-by arrangements, countries might hesitate to embark on major shifts of policy, an EFF facility would permit the authorities to make longer-term plans and more enduring commitment, and such a commitment would help to attract financial resources. The staff also noted that the balance of payments deficit was related to structural imbalances in production and trade, and thus qualified for support under the EFF decision. Narasimham, in his concluding remarks, responded point by point to the several reservations expressed in the course of the debate; he ended by saying, 'it was for the Indian authorities and the Indian people to perform and convince those of you who have doubts that we were right'. Thus the marathon debate concluded and the programme was approved, with only the US abstaining. India had carried the day. It was now left for it to deliver!

This was not the end of the Indian authorities' travails, for the government continued to be attacked in Parliament for subjecting the nation to IMF conditionalities. Intervening in the debate on the IMF in the Lok Sabha in December 1981, the Prime Minister convincingly defended the government's decision:

> The arrangement does not force us to borrow, nor shall we borrow unless it is for the national interest. There is absolutely no question of our accepting any programme which is incompatible with our policy declared or accepted by Parliament. It is inconceivable that anybody should think that we accept assistance from any external agency which dictates terms which are not in consonance with such policies.[41]

[41] Quoted in Pranab Mukherjee's budget speech for 1984–85.

The annual conference of the Indian Economic Association had rarely been known for radical posturing. So it came as a total surprise when, at its Tirupati meeting of December 1981, a near-unanimous denunciation of the government's decision to take an EFF loan was recorded. The eminent economist, late Dr P.R. Brahmananda, however, defended the government's decision. Through his book entitled *The IMF Loan and India's Economic Future*, Brahmananda sought to take his case to a wider audience. Reacting to the group of twenty-three economists' White Paper, he said their views were 'ideologically coloured'. The objective of his book was to fill the 'void in thinking about the loan and to rescue gullible youth from falling prey to political and ideological considerations' in their attitude towards the loan. In a systematic manner, he examined why India had gone for the loan, and a loan of this size. The clear intention of Brahmananda's writing was to correct distorted versions regarding the Indian loan and to remove the ideological bias by coming out as a strong defender of 'supply side economics'.

The first review of the programme was slated for April 1982. A high-powered Monitoring Committee was set up in November 1981 to monitor the various items of the programme and to keep track of performance criteria. Chief Economic Adviser Bimal Jalan was nominated as chairman of the Monitoring Committee.[42] The Committee assigned the task of compiling the monetary aggregates to the Reserve Bank. Within the Bank, a small group of senior officers[43] met Governor Patel regularly to take stock of the trends in total domestic credit, net credit to the government, gross credit to the commercial sector, net foreign assets, net non-monetary liabilities and total liquidity. Governor Patel took it upon himself to personally assess the trends to find out whether there was any possibility of overshooting the ceilings and, if so, to alert the government well in time. For this purpose, weekly internal ceilings were agreed upon between the Governor and the Bank officials; allowing for a wider degree of error in the weekly exercise, the idea was that if a persistent pattern of exceeding the agreed ceiling was perceived clearly week after week, then, it would be a reasonable indicator of future problems. Aside from the compilation of the data on time, the main input of the Bank was to follow a very active monetary policy and strive to see that it was possible to live within the operational ceilings.

[42] The following were the members of the Monitoring Committee: Chief Economic Adviser, Joint Secretary (Budget), RBI representative and Joint Secretary (Fund–Bank).

[43] The RBI group, besides the Governor, included V.B. Kadam, S.S. Tarapore, N. A. Muzumdar and K.L. Deshpande.

Records show that this task was taken seriously by the Bank and performed efficiently.

In April 1982, the Board of the IMF met to conduct its first programme review. As the programme was on track and all the ceilings in it had been meticulously observed, there was no room for criticism. Even so, the same concerns were voiced as during the passage of the loan, such as, too little financing from commercial sources, too much overlap with the World Bank, and that the arrangement should have been put on a contingent basis. The Scandinavian Executive Director went as far as to question whether India could afford the jets, but as the IMF history pointed out, he was a decade ahead of time in suggesting that there should be Fund surveillance over military purchases and to assess the financial viability of military spending.[44] Fortunately, no other Director backed him—but the Indian Director Narasimham displayed concern and dismay that the issue of military expenditure had figured in the Board, for, if allowed, it 'would open a veritable Pandora's box' and could have significant implications for the Fund's relations with member countries.

Likewise, the next two reviews (July 1982 and February 1983) posed little difficulty as the balance of payments and economic growth remained on track. Much of the improvement on both counts was attributable to the rapid development of Bombay High and the exploration of offshore oil fields. The boom in neighbouring oil exporting countries also resulted in the strengthening of invisible receipts, with migrant transfers displaying added buoyancy. Also, the incentives provided for non-resident deposits had proved highly successful. Overall, in the programme period (1981–83), the Reserve Bank followed a policy of gradual devaluation of the rupee against the basket of currencies. Besides, India had met all the performance criteria agreed upon under the EFF and made each drawing on time. The successful medium-term structural adjustment of the economy, including efficient import substitution, especially in the energy sector, drew widespread praise and admiration from the IMF Board in the subsequent review sessions.

The strategy for bringing about an improvement in the balance of payments after the sharp deterioration of 1979–80 had paid rich dividends. By the end of 1983, India had drawn SDR 3.3 billion of the original sanctioned amount of SDR 5 billion. Another SDR 600 million was availed of in Janu-

[44] See *Silent Revolution*—Minutes of EBM 82/48 and 82/49, for the remarks of Sigurdsson and Narasimham.

ary 1984, leaving a balance of SDR 1.1 billion to be drawn, subject to negotiation of the fourth year's programme. But, tactically, the government decided to forego the drawing and make an honourable exit from the arrangement. Finance Minister Pranab Mukherjee, while introducing the budget for 1984–85, had this to say about the EFF loan:

> Belying the prophecies of many a self-styled Cassandra, the economy has emerged stronger as a result of the adjustment effort mounted by us. None of the dire consequences that we were being warned about has occurred. We have not cut subsidies. We have not cut wages. We have not compromised on planning. We have not been trapped in a debt crisis. We have not faltered in our commitment to anti-poverty programmes for the welfare of our people. We entered this loan arrangement with our eyes open. We come out of it with our heads high.

The Finance Minister expressed the hope that the Indian decision to forego the balance of the IMF loan would enable the Fund to provide larger assistance to other developing countries. On 15 January 1984, in a nationwide radio broadcast, the Prime Minister announced that since the balance of payments was now strong enough, the government had decided to forego the third tranche drawing on the loan from the Fund. There was, however, a view that that was not the sole reason for giving up the last tranche: the further measures needed to meet the required financial discipline would have proved politically difficult and to avoid embarrassment, it was decided to exit graciously.[45]

A sequel worth recording here was the controversy that arose between the Reserve Bank and the Planning Commission on how the EFF drawing should be reflected in the budget. The Planning Commission was in favour of taking credit for this drawing, arguing that it was a real resource and should go towards enhancement of resources for the Plan. But the Bank refused to see it in that light. The Prime Minister was informed that the RBI Governor was adopting old-fashioned accounting norms and refusing to yield thus constraining the Plan size. The Governor, however, stood his ground and rejected the Planning Commission's approach with crystal clarity. He explained that the Fund drawings were not loans but purchases of foreign currency with Indian currency. In budgetary terms they balanced

[45] I.G. Patel, *Glimpses of Indian Economic Policy: An Insider's View.*

out and there was no net effect on the budget just as there would be none when the Fund drawing was repaid. To take budgetary credit for this transaction now would only make matters appear worse when repayments were made. The need to abide by established accounting conventions was recognized by the Ministry of Finance, which strongly supported the stand taken by the Governor.

India's EFF experiment was a classic case of a country's readiness to accept self-imposed conditionality in adjusting its economy to a changed structural scenario and aimed at tackling the root cause of the problem. It could legitimately be claimed as a precursor, even a model, for the now-acclaimed Fund objective of fostering a member country's ownership of conditionality and adjustment programmes. The success of the EFF programme was evident in the progress of the investment programme, particularly in containing the oil deficit, the mobilization of domestic resources and the resumption of growth of the economy. And this was achieved without injecting any deflationary bias into the economy.