10

Economic and Financial Environment

As the 1990s began, the Indian economy faced several uncertainties emanating from the political situation at home and the economic scenario worldwide. There was political uncertainty during 1990–91 with no stable government at the Centre until general elections were held in the middle of 1991. The macroeconomic imbalances were pronounced, which reflected in persisting fiscal constraints, external payment difficulties and elevated inflationary pressures. Despite the upheavals, the gross domestic product (GDP) growth was significant at 5.0 per cent during 1990–91. The sustainability of the growth process was, however, impeded by the structural rigidities and imbalances in the economy.

The deterioration in merchandise trade was almost entirely attributable to the rise in petroleum, oil and lubricants (POL) imports, which registered a sizeable increase in volume and a large spurt in value due to the escalation in the international oil prices. The substantial loss in the foreign exchange reserves during the early 1990s considerably reduced the pace of broad money expansion. This combined with a sluggish real economy on account of infrastructural constraints dampened savings and investment. Trends in various macroeconomic variables during the 1980s and first seven years of the 1990s are captured in Table 10.1.

Several adverse domestic and external developments precipitated the balance of payments (BoP) crisis in 1991. The combined fiscal deficit of the central and state governments, which was around 8.0 per cent during the first half of the 1980s, increased to 10.0 per cent during the second half of the decade and further to 12.0 per cent in 1990–91. Nevertheless, in the 1980s, the Government had introduced many reform measures in the areas of trade, industry and investment. The Reserve Bank, on its part,

TABLE 10.1

Decadal Trends in Key Macroeconomic Variables

Key Macro Variables		*1980–81 to 1989–90*	*1990–91 to 1996–97*
I.	*Real GDP Growth Rate (%, base 1993-94=100)*	5.8	5.8
	Agriculture	4.4	3.7
	Industry	7.4	6.9
	Services sector	6.4	6.6
II.	*Sectoral Shares*		
	Agriculture as % of GDP	36.4	30.4
	Industry as % of GDP	19.5	21.8
	Services as % of GDP	44.0	47.8
III.	*Index of Industrial Production (IIP)*	7.8	6.5
IV.	*Fiscal Indicators*		
	Centre's GFD (as % of GDP)	6.8	5.9
	States' GFD (as % of GDP)	2.9	2.8
	Combined GFD (as % of GDP)	8.0	7.4
V.	*Gross Domestic Savings as % of GDP*	19.4	23.2
VI.	*Gross Domestic Capital Formation as % of GDP*	21.2	24.7
VII.	*Inflation (Wholesale Price Index) (%, average, base 1993-94=100)*	8.0	9.7
VIII.	*Money, Credit and Banking Indicators (Growth rate)*		
	Money supply (M_3)	17.2	17.1
	Reserve money	16.8	14.7
	Aggregate deposits of SCBs	18.1	17.2
	Bank credit of SCBs	16.8	15.7
	Non-food credit of SCBs	17.8	15.7
XI.	*External Sector*		
	Export/GDP ratio	4.7	7.8
	Import/GDP ratio	7.9	10.3
	CAD/GDP	–1.8	–1.3

Notes: 1. For IIP, nine-years average was taken for the decade 1980–81 to 1989–90 at 1980–81=100.
2. SCBs: Scheduled Commercial Banks.
3. GFD: Gross Fiscal Deficit; CAD: Current Account Deficit.

Source: Reserve Bank of India, *Database on Indian Economy*; *Handbook of Statistics on the Indian Economy*, various issues; *Handbook of Monetary Statistics of India, 2006*.

rationalised the interest rates, initiated development of the money and foreign exchange markets, and reoriented its monetary management in the wake of the recommendations of the report of the committee to review the working of monetary system (Chairman: Prof Sukhamoy Chakravarty). The early reform measures were, however, sporadic and *ad hoc* and lacked a coherent approach. These did not culminate in the promotion of competition and efficiency. As a result, several macroeconomic distortions emerged. The fragile economic situation in the beginning of the year 1990 was compounded by the immediate impact of the Iraq war and led the country deeper into the crisis by mid-1991.

The Government responded quickly and put in place a programme of structural reforms. Measures were introduced to restrain imports. Alongside, the official reserves were drawn down to finance essential imports. Despite purchases of US$ 1.8 billion from the International Monetary Fund (IMF) in January 1991, gross official reserves declined rapidly to US$ 5.8 billion (equivalent of 1.3 months of imports) by end-March 1991. Inflation touched 12.0 per cent. By June 1991, there was a crisis of confidence in the country's ability to manage the BoP. The loss of confidence undermined the Government's capability to deal with the crisis and resulted in drying up of all sources of external aid. For the first time in Indian history, default on external payments had become a distinct possibility in June 1991. The Government of India (GoI), in an attempt to retrieve the situation, entered into a 20-month stand-by arrangement with the IMF on August 27, 1991 for an amount equivalent to SDR 1,656 million. This facility was formally approved on October 31, 1991.

In cognisance of the severe external sector constraints and the need to manage short-term BoP taking precedence in the economic policymaking, two sharp downward adjustments were effected in quick succession in the external value of the rupee on July 1 and July 3, 1991, in an attempt to preserve the competitiveness of India's exports. Major policy reforms were carried out on July 4, 1991 to liberalise the system from administrative controls and licences. The liberalised trade policy regime was reinforced on August 13, 1991, when higher rates of Exim scrips and decanalisation of certain import and export items were provided. Such far-reaching policy shifts were aimed at achieving macroeconomic stabilisation and structural adjustment. Despite such measures, there was no improvement in the economic scenario. Rather, a vicious cycle of events in the form of a large and growing fiscal deficit caused misalignment between monetary

expansion and real economic growth, thereby generating severe demand pressures and accelerating the pace of inflation.

It was against this backdrop that the stabilisation efforts and structural adjustment dominated the economic scene during 1991–92. This comprised fiscal correction, exchange rate adjustment and reform, fixing the monetary growth targets and inflation control as immediate measures, supported by structural reforms in the form of industrial deregulation, liberalisation of the foreign direct investment (FDI), trade liberalisation, overhauling of public sector enterprises and financial sector reforms. The reforms enveloped almost all segments of the economic system and the results were positive.

Liberalised exchange rate management system (LERMS) was introduced in March 1992. LERMS, a dual exchange rate system in transition, subsumed the explicit objective of moving towards current account convertibility in the near future. On one hand it provided a boost to exports, and on the other, it aimed at efficient import substitution with as little bureaucratic and discretionary controls as possible. The high level committee on balance of payments (Chairman: Dr C. Rangarajan) appointed by the Government in November 1991, recommended a series of measures to improve the external account.

The Union Budget for 1992–93 set out to reform the tax system based on the recommendations of the interim report of the tax reforms committee (Chairman: Dr Raja J. Chelliah). Rationalisation of the system and widening of the tax base along with lowering of tax rates for better compliance were the major tenets of the committee's advocacy.

The high level committee on the financial system (Chairman: Shri M. Narasimham) submitted its report in November 1991. The thrust of its recommendations was to ensure operational flexibility and functional autonomy for the financial system so as to enhance efficiency, productivity and profitability. The committee also advocated that the Securities and Exchange Board of India (SEBI) undertake the role of the market regulator in the capital market.

Besides the turbulence in the economic environment caused by the global and domestic circumstances, a major scam erupted in 1991 in the form of irregularities in the transaction of government securities, public sector bonds, units of the Unit Trust of India (UTI) and similar instruments. Such irregularities in securities trading by certain banks constrained the availability of liquidity and caused a crisis of confidence. At the instance of the Government, the Reserve Bank set up a committee

under the chairmanship of the Deputy Governor, Shri R. Janakiraman on April 30, 1992. The committee on trading in public sector bonds and units of mutual funds (Chairman: Shri S.S. Nadkarni) was appointed by the Reserve Bank as a follow-up to the Janakiraman Committee. On the political front, the riots in December 1992 and January 1993 resulted in severe disruptions in transport, suppressed industrial production, a decline in export volumes and revenue losses.

The mid-1990s witnessed efforts on the part of the authorities to further widen and deepen the reforms process. The initiatives in this direction led to a distinct strengthening of the BoP situation, although the GDP growth moderated. Increasing foreign capital inflows and a sharp improvement in the current account of the BoP resulted in a substantial expansion in the foreign exchange reserves. The composition of capital inflows exhibited a major shift from debt creating to non-debt creating flows. On the flip side, there was monetary expansion and consequent inflationary pressures. The macroeconomic developments brought the focus squarely on the necessity of the monetary policy and the exchange rate policy to be aligned. It was in this context that the Reserve Bank moderated monetary expansion through open market operations (OMOs) while the foreign exchange reserves increased.

As a consequence, there was a turnaround in terms of higher real GDP growth, recovery in the agricultural and industrial sectors, subdued inflationary pressures, resilient export performance, comfortable foreign exchange reserves and improved economic confidence. These positives rendered the manoeuvre of macroeconomic policies easier. India's sovereign rating was revised by a host of agencies including Moody's and the Japan Bond Research Institute, that reflected the prudence exercised in management of the external debt.

External current account convertibility was formalised, trade restrictions were relaxed and tariff rates were rationalised. The financial sector witnessed expansion with the entry of a number of entities offering a wide range of services. Greater financial integration resulted in enhanced competitive efficiency and banks showed improved performance. There were, however, concerns on capital inflows and sharp credit expansion.

The second half of the 1990s, therefore, experienced distinct signs of stability, strengthening of the process of fiscal consolidation and a clear upward shift in the perception of the long-term growth prospects of the economy. In an open economy framework, while the foreign exchange reserves increased, the real effective exchange rate (REER) appreciated

to a certain degree with an impact on export performance, against the backdrop of subdued global demand. The lower-than-expected industrial sector performance continued to cause concern to policymakers. There was, however, growing consensus in political circles in favour of the reforms process.

A historic agreement was reached between the Government and the Reserve Bank on September 9, 1994 to phase out automatic monetisation of the budget deficit through the issue of *ad hoc* Treasury Bills over a period of three years and discontinue this instrument from 1997–98. This was followed by the introduction of ways and means advances (WMA) facility with effect from April 1, 1997 to help the Central Government meet mismatches in its revenue and expenditure. The period 1990–91 to 1996–97 was, thus, marked by conscious efforts on the part of the Government and the Reserve Bank to strengthen fiscal discipline, which provided much needed space to the Reserve Bank for monetary management.

The most striking aspect of the Indian economy in the 1990s was that it not only managed its worst BoP crisis in the 1991 remarkably well, besides turning around its external sector, but also remained relatively insulated from the contagion of the South-East Asian crisis that began in 1997–98.