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The Balance of Payments Crisis of 1991

INTRODUCTION

Until the early 1980s, India's economic policy was dominated by pervasive administrative controls and had a strong inward orientation. The process of gradual decontrol and easing of restrictions began in the mid-1980s. The initial focus of liberalisation was on relaxation of licensing for entry, expansion in industry and on freeing access to imports, particularly of inputs and capital goods for export production. From 1985, there was also an emphasis on promoting exports encompassing some direct measures such as easier access to imports, tax relief, preferential credit, subsidies to compensate for differences between international prices and domestic prices of inputs, and a supportive exchange rate policy. The Reserve Bank on its part also initiated several measures to rationalise interest rates and develop the money and foreign exchange markets, and gave a new orientation to monetary management, following the Chakravarty Committee report. These early reform measures, however, suffered from the lack of an overarching framework to promote competition and efficiency. Consequently, the emergence of several macroeconomic distortions could not be averted.

India achieved significant pick-up in the growth rate averaging 6.0 per cent during the Seventh Five Year Plan period and a high of 7.6 per cent during the three-year period ending 1990–91. While this was partly induced by highly expansionary fiscal policy, it was aided by the measures of liberalisation introduced in trade, the industrial sector and taxation policies at that point.

The first half of the 1980s saw a large increase in the central government deficit, primarily on account of high expenditure levels, especially on agricultural subsidies, defence and interest payments. On the external account, higher imports dominated over acceleration in exports. A steady deterioration in the services account resulted in widening of the current account deficit (CAD) and, with the aid inflows not increasing commensurately, the increasing reliance on commercial sources for financing resulted in the debt-service ratio rising to nearly 30.0 per cent in the late 1980s.

By 1990, there was a realisation in official circles that the widening of fiscal deficit and the related rise in money growth were contributing to a rise in inflation and exerting pressure on the balance of payments (BoP). The Reserve Bank had evidently been expressing its concern to the Government about the adverse implications of the deteriorating BoP position and the impact of rising fiscal deficit since the late 1989, but timely preventive measures were stalled by the uncertain political situation.

There was a step-up in external commercial borrowings (ECBs) in 1988–89 and 1989–90. The policy stance was that commercial borrowings were to be resorted to only for financing designated institutions and activities and not for general BoP support. Commercial borrowings were expected to drop in 1990–91. Reliance on non-resident deposits continued, with interest rates on these deposits kept slightly above international market levels. These deposits were considered to be advantageous as a stable source of external financing.

India was thus faced with large internal and external financial imbalances and was vulnerable to adverse external shocks around 1990. Previously India had relied almost exclusively on aid on concessional terms. The 1980s saw a growing resort to financing on commercial terms and therefore by the end of the decade its debt-service ratio became relatively high by regional standards. Second, the official reserves, which until then had been relatively stable at a high level, were drawn down from about five months of imports in the mid-1980s to only a little over two months of imports at the end of 1989–90. Despite purchases of US$ 1.8 billion from the International Monetary Fund (IMF) in January 1991, gross official reserves stood at US$ 5.8 billion (1.3 months of imports) by end-March 1991.

Inflation rose to 12.0 per cent. The consequent fragile economic situation was compounded by the sudden impact of the Iraq war, leading the country deeper into the crisis by the mid-1991. The higher oil prices and loss of workers' remittances weakened the current account position by US$ 1.5 billion in 1990–91. The impact of the crisis was further exacerbated by policy slippages. A sizeable reduction in fiscal deficit had been planned for 1990–91, but it did not materialise, and bank credit to the Government continued to grow rapidly. Expansionary financial policies continued to put pressure on domestic prices and the external CAD widened to 3.0 per cent of gross domestic product (GDP). Owing to market concerns about the deteriorating external position and domestic political uncertainty, recourse to ECBs was not available from the mid-1990.

The external liquidity situation remained extremely tight in the first quarter of 1991–92 owing to a number of factors, such as the withdrawal of non-resident Indian (NRI) deposits, outflows of short-term capital from banks, and lacklustre export performance. The withdrawal of NRI deposits, which started in September 1990, intensified and was accompanied by an outflow of short-term capital as commercial banks failed to renew credit lines. Exports stagnated, largely because of slack demand in key markets in the industrial nations and the Middle East, as well as growing disruptions to trade with the USSR. Political events, in particular the resignation of the Government in March, 1991 and the postponement of general elections, prevented major fiscal action, and the burden of adjustment fell mainly on monetary tightening and direct import compression measures. Despite a sharp fall in import volumes, gross official reserves declined further to US$ 1.7 billion (about three weeks of imports) by end-June 1991.

By the mid-1991, the BoP crisis turned into 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 by closing off all recourse to external credit. A default on payments for the first time in Indian history became a serious possibility in June 1991.

The Reserve Bank in its Annual Report for the year 1991–92 enunciated the underlying causes and events that resulted in the economic crisis:

> The preceding decade had seen acceleration in economic growth, but the relatively high rate of growth of GDP was also associated with macro-economic imbalance and the persistence of structural rigidities, a certain degree of which constrained the sustainability of the growth process. Continuing macro-economic imbalance and a delay in taking corrective action in time accentuated the impact of global economic shock of 1990.

> Large and growing fiscal deficit with a sizeable component of monetised deficit inevitably resulted in rapid growth of monetary liquidity far out of alignment with the real economic growth, thereby generating severe demand pressures and accelerating the pace of inflation. These imbalances in turn spilt over onto the external sector in the form of a large and unsustainable current account deficit. The persistently high levels of fiscal deficit and current account deficit on the balance of payments (BoP) gave rise to a sizeable public debt, both domestic and external. The country was faced with a risk of default on external debt servicing during the early months of the fiscal year 1991–92. The strain on external and internal resources, the threat to monetary stability and the resultant inflationary process, had begun to hinder investment plans both in the public and private sectors, giving rise to distortions in production and employment generation. The situation called for strong stabilisation measures: fiscal correction, monetary tightening, inflation control, and strengthening of the competitiveness of India's exports.

In essence, a confluence of economic and political factors was under play in the build-up to the crisis. The Government requested a 20-month stand-by arrangement from the IMF on August 27, 1991, for an amount equivalent to SDR 1,656 million. This facility was approved by the IMF on October 31, 1991. The arrangement became an opportunity for both the Government and the Reserve Bank to embark upon a series of home-grown reforms in the real and financial sectors.

MAJOR CONTRIBUTING FACTORS: PRE-CRISIS DEVELOPMENTS

WORSENING FISCAL SITUATION

From 1979 onwards, the second oil shock, agricultural subsidies and consumption-driven growth had pushed up fiscal deficit. It further enlarged in the mid-1980s as defence expenditure was substantially increased and direct taxes were progressively reduced. The result was that fiscal deficit as a percentage of GDP escalated to 9.4 per cent in 1990–91 as against the average of 6.3 per cent in the first half of the 1980s.

The monetisation of fiscal deficit resulted in higher liquidity growth over and above the overhang of liquidity carried forward from the earlier years and the consequent expansionary impact on money supply. To some extent, the Union Budget for 1989–90 sought to correct the growing imbalances between revenues and expenditures. However, the outcome turned out to be much worse because the imbalances did not stem from any let-up in government revenue mobilisation but due to increases in the government expenditure, which in turn was financed by larger borrowings and the budget deficit. The Centre's budgetary deficit in 1989–90 (according to the Reserve Bank's records) was much higher, by about 30.0 per cent, than the budgeted amount. Likewise, the Reserve Bank credit to the Central Government in 1989–90 was more than twice the actual for 1988–89.

The widening of the budgetary deficit on revenue account and the growing recourse to borrowings from domestic and external sources to finance the deficit had several adverse consequences. First, to the extent that this entailed recourse to the Reserve Bank, the deficit turned out to be the principal factor propelling high rates of monetary growth, which, in turn, fuelled inflationary pressures and expectations. Second, the greater recourse by the Government to borrowing from the commercial banking system as well as directly from the households claimed a higher proportion of household savings for government expenditure, leaving a lower proportion for use in directly productive sectors, such as industry and agriculture. Third, the mounting stock of public debt led to mounting interest payments on the Government's revenue account, which exacerbated the problem of continuing revenue account deficits and pre-empted an increasing fraction of the government expenditure to meet such debt-service obligations. Finally, the high deficit spilled over into the BoP gap, with the resultant drawdown of foreign exchange reserves.

THE SPILL OVER OF FISCAL DEFICIT INTO CURRENT ACCOUNT DEFICIT

Imbalances in the external sector reflected the fundamental fact that aggregate absorption in the economy was in excess of domestically produced goods and services. In other words, imbalances between aggregate demand and supply ultimately spilled over onto the BoP and the gap had to be met by either running down the reserves or increasing debt.

In India, it was the fiscal deficit of the Government that was associated with excess demand and the consequent deterioration of the current account balance. The fiscal deficit was nurtured principally by a large expansion in net Reserve Bank credit to the Central Government against the issue of *ad hoc* Treasury Bills, which came to be popularly known as automatic monetisation of deficit. The Seventh Five Year Plan period also witnessed deterioration in the fiscal imbalances as the ratio of gross fiscal deficit (GFD) to GDP escalated from 6.3 per cent in the first half of the 1980s to 8.2 per cent during 1985–1990. The net outcome of this pattern of financing was that the spiral of increased borrowings and deficit financing pushed up the interest payments, liquidity growth and inflation.

The not-so-apparent and yet the close link between the budget deficit and CAD was aptly stated in the Economic Survey for the year 1988–89 thus:

> Though it has not been appreciated, it must be recognised that high levels of fiscal deficits tend to spill over and contribute to high current account deficits in the balance of payments. An improvement in the current account of the balance of payments requires a commensurate reduction in the overall savings-investment gap of the economy. In a situation such as ours where the recent widening of the savings-investment gap is largely attributable to deterioration in the budgetary savings, the turn-around in the budgetary performance will contribute substantially towards a sustained improvement in the balance of payments.

The same relationship was highlighted in the Annual Report of the Reserve Bank for the year 1992–93:

> Quite often, monetary policy and exchange rate policy are discussed as separate and distinct segments of overall financial policy. These two segments are invariably intertwined and as a market-based system develops, it would no longer be meaningful to view these as separate segments of policy. If these two segments are not made mutually consistent, one or the other segment of policy could be greatly attenuated.

WIDENING CURRENT ACCOUNT DEFICIT

Before the onset of the 1991 crisis, two instant external shocks contributed to widening of the CAD. First, Iraq's invasion of Kuwait in 1990 exposed India to sudden shifts in global oil prices. This also caused the return and rehabilitation of the Indians working in that region, adversely affecting the inflow of remittances. The petroleum import bill in 1990–91 increased over 50.0 per cent to US$ 6.0 billion. By September 1990, the net inflow of NRI deposits had turned negative. Access to commercial borrowings became costlier and more difficult, and by December 1990 access to even short-term credit, particularly the bankers' acceptance facility (BAF), was constrained. The foreign exchange reserves fell to US$ 1.2 billion in January 1991.

The second shock was the slow economic growth in India's export markets. Growth in the US — India's largest export destination — fell from 4.1 per cent in 1988 to (–)0.2 per cent in 1991. Conditions in another major export market — the Soviet Union — worsened due to the oil shock. World growth declined from 4.5 per cent in 1988 to 2.2 per cent in 1991. Consequently, India's export growth was only 4.0 per cent during 1990–91. Further, India's export competitiveness was adversely affected by a steady appreciation in the rupee's real effective exchange rate (REER): 20.0 per cent between 1979 and 1986. From 1987, the rupee steadily depreciated, but the real exchange rate remained overvalued until the year of the crisis.

The Reserve Bank in its Annual Report for the year 1989–90 expressed the view that given the small size of the external sector, the CAD experienced in the Seventh Plan period was of a large order and was worrisome, and the Bank wanted the CAD to be reduced to around 1.5 per cent of GDP by according emphasis to higher exports. On the issue of financing the CAD, which assumed grave proportions soon thereafter and hastened the crisis (of imminent default in repayments), the Reserve Bank made the following pertinent observations in the report:

> So far the bulk of financing the current account deficit has been provided by external assistance, commercial borrowings and NRI deposits. The outlook for concessional aid is not bright. There has already been a hardening of the terms from multilateral institutions and there are many more claimants to the resources of multilateral and bilateral donors. As regards commercial borrowings, although we have pursued a prudent policy, the recourse to this source of borrowing has been rising in the last few years. While India can continue to borrow from the capital market at fine terms on account of its impeccable record of debt service, the recent policy stance for still greater caution is appropriate. The inflow of NRI funds under FCNRA scheme is also becoming a high-cost source of financing given the rise in the interest rates abroad. The inflow of direct foreign investment capital into India is very small being around $200 million a year as compared with much higher inflows in respect of many other countries in Asia. A larger inflow of direct foreign investment will help to reduce the pressure on the balance of payments.

CHANGING COMPOSITION OF EXTERNAL DEBT

The changing composition of external debt, which shifted from official to commercial and towards the short-term, was one of the factors contributing to the external imbalance. Besides long-term and medium-term debt, there was also short-term debt in the nature of trade credit and suppliers' credit, and the BAF relating to imports. Such facilities were contracted for public sector undertakings (PSUs), and the outstandings were being financed through rollover of inter-bank borrowings. This amounted to US$ 3,551.0 million as at end-March 1991.

The increasing trend of availability of ECBs during the later part of the 1980s was reversed in 1990. A major reason was a fall in the overall availability of international credit due to the capital adequacy requirements of the Bank for International Settlements (BIS). Commercial banks were compelled to restrict credit expansion and were expected to strengthen their capital base. The gulf crisis created an atmosphere of uncertainty in the international capital market, with an adverse impact on developing countries that depended on oil imports, like India. The third factor was the downgrading of India's credit rating for long-term funds by international rating agencies in March 1991; India's rating slipped to the bottom of the investment grade. This prompted international banks to restrict the renewal of the rollover facility of inter-bank borrowings for Indian banks. The situation led to difficulties in the retirement of import bills for Indian importers and PSUs.

The share of external assistance in total debt stock declined to less than 70.0 per cent in 1989–90 as against almost 90.0 per cent during the Sixth Five Year Plan. The declining share of external assistance in external capital inflow, hardening of the terms for such assistance and a rapid rise in the rate of interest contributed to bunching of the debt-service payments in the late 1980s.

OVERVALUATION OF THE RUPEE

Since 1987, the Indian rupee had been depreciating in real terms as compared with many of India's trade competitors. However, between October 1990 and March 1991, the REER of the rupee appreciated by about 2.0 per cent as a result of widening inflation differentials between India and the major industrialised countries, and the REER increase was continuing, albeit slower than the nominal depreciation (2.4% against five currencies, over the same period). Further, in the 5-month period between February 1991 and June 1991, the nominal effective exchange rate (NEER) decreased by only 2.5 per cent, while the inflation differentials continued to widen. All this resulted in eroding India's international competitiveness.

DOMESTIC POLITICAL UNCERTAINTY

The country also faced intense political uncertainty during this period. The general elections were held in November 1989, followed by the formation of a coalition Government. Internal political conflicts among the coalition partners on a variety of issues caused the Government's fall by November 1990. A group of Members of Parliament (MPs) broke off from the erstwhile Government and a new Government was formed in November 1990. This support was, however, withdrawn in February 1991, and the scheduled budget could not be passed. In the midst of campaigning for general elections, the Prime Minister was assassinated in May 1991. General elections were held in May 1991 and the elected Government took over only by June 1991. Thus, within a span of two years, during which the country faced a strained BoP position, there were three unstable governments at the Centre.

BREAK-UP OF THE SOVIET BLOC

Rupee trade with the Soviet bloc was an important element of India's trade in the 1980s. Exports to Eastern Europe comprised 22.1 per cent of total exports in 1980 and 19.3 per cent in 1989. A significant proportion of the trade, constituting imports of capital goods and defence equipment, was financed by long-term trade credits. The trade with these countries was carried out under the rupee payment agreement (RPA), which provided a framework for the size of turnover and commodity composition with each country. During 1990–91, only three countries, *viz.*, the USSR, Czechoslovakia and Romania, settled their payments under the RPA. However, the trade was dominated by the USSR, which accounted for 95.0 per cent of the total trade turnover between India and the three countries under the RPA. Further, India enjoyed a surplus trade balance with the USSR for almost the entire period of the 1980s. The trade surplus in favour of India rose from US$ 268.0 million[1] (₹ 212 crore) in 1980–81 to US$ 1,456.5 million (₹ 2,425 crore) in 1989–90 and further to US$ 1,512.6 million (₹ 2,714 crore) during 1990–91.

With the introduction of Glasnost and the breaking away of the Eastern European countries, several rupee payment arrangements were terminated

1. Conversions are based on annual average rupee-dollar exchange rate.

in 1990–91. Thus, the RPA with the former German Democratic Republic ended in December 1990 with German reunification, and with Poland the agreement ended in January 1991. As a consequence of these and other political developments in Eastern Europe, the flow of new rupee trade credits declined abruptly in 1990–91. The exports share of the Eastern European countries in India's external trade also declined to 17.9 per cent during the same period. Such developments raised concerns about future difficulty in exporting to these markets. The collapse of the USSR in December 1991 added further woes to rupee trade arrangements with Eastern European countries. As a result, the share of Eastern Europe in India's exports collapsed to 10.9 per cent in 1991–92. The breakdown of traditional arrangements also meant an interruption in new rupee credits and a consequent increase in the net repayment on the rupee debt account.[2]

THE GULF WAR

The gulf crisis, which began with the invasion of Kuwait by Iraq on August 2, 1990, lasted about seven months until February 28, 1991. The gulf crisis was different in terms of its impact from the earlier two oil shocks. First, it did not have some of the compensating features of the earlier shocks, *viz.*, large inflows of remittances, a surge in exports and a tendency for non-fuel commodity prices to rise in sympathy with oil prices. Second, it imposed an additional cost of repatriating NRIs from affected countries in the region. Third, the crisis adversely impacted international capital markets.

The turmoil in the world oil market emanated from the trade embargo on Iraq and Iraq-occupied Kuwait, which together contributed about 6.8 per cent and around 7.5 per cent of the world oil per day consumption and production, respectively, during 1991. Given that in the short run the price elasticity of both supply and demand was rather low, an increase in oil prices in response to supply decline was inevitable.

The gulf crisis had a serious impact on India's petroleum, oil and lubricants (POL) import bill. First, alternative sources for imports of crude oil and petroleum products had to be identified to substitute for imports earlier obtained from Iraq and Kuwait. Second, since contracts for crude oil and products were market-related, higher prices entailed a sharp escalation in the import bill of POL. The level and volatility of oil prices increased sharply after the invasion of Kuwait by Iraq in August

2. Virmani, Arvind (2001). "India's 1990–91 Crisis: Reforms, Myths and Paradoxes", *Working Paper* No. 4/2001-PC. New Delhi: Planning Commission. December.

1990. From an average of about US$ 15 per barrel during April–July 1990, the average prices paid by India for crude in the world market doubled to US$ 30 per barrel during August–November 1990 and then declined to an average of US$ 19 per barrel during the rest of 1990–91. Similarly, the average price of petroleum products rose from about US$ 182 per tonne to US$ 354 per tonne and then declined to US$ 313 per tonne, over the same period. The prices, both of product and crude, softened from December 1990 to March 1991. However, while crude oil prices fell sharply, product prices declined relatively slowly. The fall in crude prices was more than 36.0 per cent during December 1990–March 1991 over the preceding four months, while product prices declined by only about 12.0 per cent over the same period.

The spurt in the prices of crude oil and petroleum products caused a sizeable increase in the POL bill. The POL bill during 1990–91 was estimated at around ₹10,820 crore (US$ 6.0 billion) as against ₹ 6,273 crore (US$ 3.8 billion) for 1989–90. This indicated an increase of about 72.0 per cent in rupee terms and 58.0 per cent in dollar terms. Assuming that the price of oil and products had remained at the same level (US$ 14.77 per barrel for crude and US$ 181.5 per metric tonne for products) prevailing during April–July 1990 for the rest of the year as well, the direct additional cost of POL imports would have been around US$ 2.2 billion (₹ 3,900 crore). After adjusting for exports of petroleum products, the net POL burden was estimated at US$ 2.0 billion (₹ 3,625 crore).

The gulf crisis constrained India's export performance during 1990–91 in more than one way. In 1989–90, the West Asian countries accounted for 7.2 per cent of India's exports, with Kuwait accounting for 0.7 per cent and Iraq about 0.5 per cent. The immediate impact of the gulf crisis arising out of the trade embargo on Iraq and occupied Kuwait, and dislocation of trade to other countries in West Asia led to a significant loss in exports. The total loss of exports in the gulf region was estimated at US$ 3,003.0 million, including US$ 1,622.0 million on account of loss of exports to Kuwait and Iraq alone. Besides, India could not realise her dues to the extent of US$ 64.0 million under deferred payment arrangements and about US$ 50.0 million under the projects outside deferred payment arrangements during 1990–91.

The direct overall adverse impact of the gulf crisis lasting for about seven months from August 1990 to February 1991 on the current account of India's BoP for the fiscal year 1990–91 was estimated at US$ 2,987.0 million, equivalent to ₹ 5,180 crore (Table 11.1). It must be emphasised that this impact assessment was relative to a normal situation free of the gulf crisis.

TABLE 11.1

Direct Balance of Payments Impact of the Gulf Crisis during 1990–91

Item	*₹ crore*	*US$ million*
Additional POL import bill (net of POL exports)	3,625	2,020
Export loss to West Asia	500	280
(of which: Iraq and Kuwait)	(270)	(150)
Non-realisation of other export dues from Iraq	205	114
Loss in remittances from Iraq and Kuwait	490	273
Foreign exchange costs of emergency repatriation	360	300
Total	5,180	2,987

Source: Government of India, *Economic Survey, 1990–91.*

The gulf crisis clearly impacted the balance of trade situation. During 1990–91, imports were 22.0 per cent higher than that in 1989–90, largely on account of POL imports, while exports rose by 17.5 per cent, as a result of which the trade deficit at US$ 9,437.0 million was 38.0 per cent higher than that in 1989–90. Consequently, there was a rapid drawdown of foreign exchange reserves during 1990–91. Foreign currency assets (FCA) held by the Reserve Bank declined by US$ 3,460.0 million during the year despite the BoP support received from the IMF.

REPATRIATION OF INDIAN NATIONALS FROM IRAQ: IMPACT ON INVISIBLES

The gulf crisis had a significant adverse impact on the flow of remittances into India. During the period 1982 to 1986, Iraq and Kuwait accounted for 12.0 per cent of annual labour outflows from India. In 1987, these two countries accounted for about 14.0 per cent of the estimated migrant population of about one million in West Asia. In 1988–89, about 8.5 per cent and 0.2 per cent of total private transfer receipts (remittances) came from Iraq and Kuwait, respectively. As estimated by the Government, the loss in private remittances from Kuwait and Iraq was placed at US$ 273.0 million (₹ 490 crore) during 1990–91.

The gulf crisis also had an adverse impact on the capital account. The fall in capital inflows compounded the problem of financing the rising level of CAD. Inflows into non-resident accounts and ECBs were the two major components of the capital account, which suffered most under the impact of the gulf crisis.

The gulf countries accounted for about 35.0 per cent of foreign currency non-resident (account) [FCNR (A)] flows, with Kuwait contributing 2.0 to 3.0 per cent of these and Iraq only a negligible amount during the early 1990s. Net inflows into these accounts from all sources declined to US$ 142.0 million in 1990–91 from US$ 1,309.0 million in 1989–90. The gulf countries contributed about 65.0 per cent of non-resident (external) rupee account [NR(E)RA] flows, with Kuwait accounting for 18.0 per cent and Iraq an insignificant proportion during the period 1982–86. During the years 1989–90 and 1990–91, there were net outflows from the NR(E)RA amounting to US$ 2.4 million in 1989–90 and US$ 30.0 million in 1990–91. It was estimated that the gulf crisis was responsible for a shortfall of at least US$ 500.0 million in the non-resident accounts.

In 1990, there was a marked slowdown in borrowings from the international capital market by the developing countries as a group. All major segments of the international financial market experienced a contraction during the year against the background of deteriorating global conditions and uncertainties arising from political and economic consequences of the gulf war. From the second half of 1990, markets became increasingly selective and were reluctant to take risks. Creditworthiness considerations became paramount and capital adequacy requirements constrained the lending activity of banks. These adverse conditions persisted till the end of 1991. Against this backdrop, India's commercial borrowings in terms of commitments dropped sharply to US$ 1,903.0 million in 1990–91 from US$ 3,291.0 million in 1989–90. The gulf crisis triggered adverse market perceptions about Indian risk during the year. This affected the availability of commercial funds to India during 1990–91. The evacuation of about 1,80,000 Indian workers from Kuwait and Iraq and their repatriation to India was estimated to have cost the country US$ 200.0 million.

LOSS OF CONFIDENCE ABROAD

By November 1990, the Government lost the crucial vote of confidence in Parliament. In its place, a minority Government was formed. The Union Budget due at the end of February 1991 was postponed and instead, a vote on account was presented on March 4, 1991.

The memorandum to the Central Board of Directors of the Reserve Bank dated November 24, 1990 summed up the fiscal response of the Government as follows:

> The Gulf crisis adversely affected the domestic fiscal scenario. In order to deal with the steep rise in the international price of crude and its concomitant rise in the import bill as also to meet the cost of evacuating non-resident Indians from Kuwait and Iraq, the Government adopted a combination of measures such as rise in petroleum prices, curbs in consumption of petroleum products and enhanced tax effort. These included a 'Gulf evacuation' surcharge of 10 per cent on passengers on Indian Airlines to yield Rs. 40 crore in the current year and Rs. 100 crore in the full year and an additional surcharge on corporate incomes of 7 per cent to yield Rs. 100 crore in the assessment year 1991–92. Furthermore, a 25 per cent increase was announced on October 14, 1990 in prices of petrol and most other petroleum products, excluding domestic cooking gas (LPG).

It became clear by the beginning of 1991–92 that the payments crisis was no longer primarily due to the trade deficit, and there were expectations of default and therefore devaluation. This created longer leads in the payments for imports and lags in the realisation of export proceeds, which attenuated the foreign exchange shortage.

A mention may be made of the conscious attempt by international banks to reduce exposures in order to meet capital adequacy norms. Following this, the country's access to short-term credit, particularly the BAF, became restricted. International rating agencies lowered the credit ratings of India/Indian entities, which made it difficult to raise funds in the commercial markets. Short-term credit by way of bankers' acceptance lines and six-month credits were available at 0.25 per cent above London interbank offered rate (LIBOR, the standard reference interest rate in international commercial borrowings) until November 1990. Thereafter, the cost above LIBOR went up to 0.65 percentage points in March 1991, which rose further to 1.25 percentage points by May that year. By June, the overall cost of credit was even higher. Under such circumstances, the Government had to accord top priority to ensure that external payment obligations were met and that the foreign exchange reserves were maintained at a reasonable level.

RESERVE BANK ALERTS THE GOVERNMENT

From 1988–89, the Reserve Bank had been continually alerting the Government regarding the adverse consequences of growing government deficits, their impact on the external payments situation and the worsening BoP position. The Governor also hinted at the possibility of approaching multilateral institutions to find a remedy.

APPRAISING THE GOVERNMENT OF DETERIORATION IN BALANCE OF PAYMENTS

In December 1988, the Reserve Bank drew the attention of the Government to the severe strains in the BoP of the country. A review done in May 1990 showed that the position had continued to be difficult in the previous year and that the prospects for improvement in the ensuring year appeared bleak. The foreign exchange reserves (comprising the foreign currency assets, gold and SDRs) continued to decline during 1988–1989, and the real loss in reserves was much higher if special transactions were excluded. These special transactions included the funds brought in, receipts from the India Supply Mission (Washington), the Indian Embassy (Tokyo) and sales of foreign currencies to the Reserve Bank by Industrial Credit and Investment Corporation of India (ICICI) Ltd, Industrial Development Bank of India (IDBI) and the Industrial Finance Corporation of India (IFCI). Besides, there was an increasing resort to short-term credit, the outstandings of which went up by US$ 1,186.3 million (₹ 1,718 crore) to US$ 2,162.7 million (₹ 3,132 crore) during 1988–89, *i.e.*, more than twice the rise of US$ 547.6 million (₹ 710 crore) during 1987–88. The CAD during 1988–89 was then estimated to be 2.7 per cent of GDP as against 1.9 per cent in 1987–88, which exceeded the earlier high of 2.3 per cent, reached in 1985–86.

The Reserve Bank in a communication dated May 24, 1989 to the Government focused on wide-ranging key policy measures needed to correct the situation, *i.e.,* export promotion, exchange rate policy and containment of the fiscal deficit of the Government. After recounting the disturbing trends in the foreign exchange reserves, the Reserve Bank conveyed its concerns over the situation as follows:

> From all accounts, it appears that if no strong policy actions are initiated, the trade deficit in 1989–90 will even be higher than that in 1988–89. Oil prices have already started rising and the increase in commodity prices in general may cause the import bill to

> increase faster. Apart from the fact that the rising current account deficit has serious implications for debt servicing in the future, even in the short run there can be difficulties in financing a deficit of this order. Last year, we had allowed the reserves to fall to the extent of Rs. 1,500 crore. We cannot allow any further decline in reserves which are now equivalent only to two-and-a-half months of imports. All these point to the need for decisive action to limit the trade and current account deficits.

The Reserve Bank urged the Government to accord more attention to the export sector by creating adequate surpluses out of production for the purposes of export, and at least in some sectors it emphasised that exports must become a matter of primary concern rather than being a residual after meeting domestic demand. This was in addition to the number of incentives provided to exporters and a highly supportive exchange rate policy. Turning next to the exchange rate policy, the letter explained that the NEER of the rupee against five major currencies had come down from 100.0 in 1979 (average) to 52.1 in 1988 (average). The REER of the rupee in relation to five major currencies, which took into account the movement of prices in the respective countries, had come down from 100.0 in 1979 to 81.9 in 1988. Thus, there was a considerable depreciation of the rupee in real terms in relation to the currencies of India's major trading partners and competing countries. The communication from the Reserve Bank to the Government added, "There is no doubt that exchange rate adjustments have played an important role in accelerating exports in the recent period." The letter suggested that having achieved a strong measure of real depreciation, exchange rate adjustments in future must be used primarily to correct price differentials between India and its trading partners. The ground rules under which the exchange rate policy could be effective and its linkages with other policy areas were described thus:

> Exchange rate depreciation works through improving the competitiveness of Indian exports and curbing import demand. The extent to which external imbalances can be corrected depends upon the elasticity of exports and imports to price changes. And more importantly, a reduction in trade deficit through exchange rate changes can be brought about only if the overall expenditure are contained in the economy and increase in the domestic price level is effectively contained. Otherwise, the advantages of devaluation will be wiped out very soon.

The next topic of discussion in the communication was the link between the fiscal deficit and the CAD. The Reserve Bank stressed that if the CAD in 1989–90 was not to exceed that in the previous year, the fiscal deficit should be contained at the level actually achieved in 1988–89 and that one way of doing this was for the Government to examine the expenditures under all heads and bring about overall reduction and also make efforts to reduce the import content of government expenditure, including those on defence. This was considered to be particularly pertinent because exchange rate depreciation might not by itself be adequate to contain import demand and this was all the more so in commodities, such as POL products and fertilisers, whose ultimate prices to the consumers had not been suitably altered upwards. In the case of bulk commodities for which exchange allocation was made directly by the Government, a careful pruning of imports was needed. Another relevant point made was that while trade policy did not encourage the import of finished consumer products, care had to be taken that this policy was not undermined by liberal imports of their components.

The concluding paragraph of the letter from the Reserve Bank summed up the responsibilities of the Government in order that the BoP situation did not get out of control:

> The balance of payments position of the country is passing through a very difficult phase. Current account deficits of the order seen in 1988–89 cannot be sustained. A comprehensive policy package needs to be drawn up to limit the deficits to more reasonable levels. In any such scheme, besides accelerating exports, equal attention must be paid to import planning so as to limit the growth of imports. A greater control over Government expenditures and a reduction in budget deficit are equally necessary, if the various policy measures aimed at increasing exports and reducing the volume of imports is to become effective.

UPSURGE IN INFLATIONARY PRESSURES

The large growth in overall liquidity and the consequent pressure on the price level was evident until September 1989. The Reserve Bank was, however, constrained from deploying the cash reserve ratio (CRR) as it had reached the statutory ceiling of 15.0 per cent. This prompted the Governor to bring the situation to the notice of the Principal Secretary to the Prime Minister. While the main message in the letter to that effect is covered in the subsequent chapter on monetary management, it suffices to state here that the thrust of the letter was to supplement the monetary measures by fiscal measures for an effective anti-inflationary package.

CRITICAL BALANCE OF PAYMENTS SITUATION

The Governor was closely monitoring the developments and was seriously concerned with the alarming scenario in the country's BoP situation. The Reserve Bank communicated its concerns in a detailed letter of February 19, 1990 to the Government, giving the factual details of the external position as follows:

> Foreign exchange reserves during the current financial year up to February 2, 1990 had declined by Rs. 1,409 crore to Rs. 5,630 crore, as against a fall of Rs. 1,948 crore in the corresponding period. However, the real loss in reserves turned out to be much higher. But for the special transactions the loss of reserves would have been higher. Reserves in the current year had benefited from the inflow of funds under the Foreign Currency (Non-Resident) Accounts (FCNRA) Scheme. The net inflow of funds under this scheme during the current year up to February 2, 1990 amounted to Rs. 2,377 crore, higher by 48.0 per cent than those of Rs. 1,607 crore in the corresponding period of 1988–89. The net inflow of aid, however, had been lower than in the last year. Coming to the crux of the balance of payments problem, the grim picture was as follows.
>
> The balance of payments had been under considerable pressure since the beginning of the Seventh Plan. Foreign exchange reserves in SDR terms steadily declined from SDR 6,004 million at the end of March 1985 to SDR 2,815 million by the end of December 1989. The current account deficit more than doubled from Rs. 2,852 crore in 1984–85 to Rs. 5,927 crore in 1985–86. Although it came down somewhat in the following year, it went up to Rs. 6,293 crore in 1987–88 and is estimated to have reached an all-time high of the order of (Rs. 10,430 crore) in 1988–89 or 2.7 per cent of GDP. The balance of payments continues to be under pressure during the current financial year. Based on the capital transactions, the current account deficit during April to December 1989 would seem to be running higher than in the corresponding period of 1988, although in U.S. dollar terms, it would be somewhat smaller

than in the last year. The annual average ratio of current account deficit to GDP of 2.2 per cent during the first four years of the Seventh Plan as against the targeted average of 1.6 per cent for the Plan period underscores the pressure on balance of payments.

The reasons for the large CAD experienced in the Seventh Plan period were both large trade deficits and deterioration in the invisibles account. While India had large trade deficits, the invisibles account — which had given a measure of support to BoP — had also deteriorated. Net invisibles receipts excluding official transfers, which financed as much as 92.0 per cent of the trade deficit in 1978–79 and 65.0 per cent in 1980–81, could offset only 51.0 per cent of the trade deficit in 1984–85, and were as low as 21.0 per cent in 1988–89. The surplus on the invisibles account was mainly due to private transfers. If private transfers were excluded, the invisibles account would show a deficit from 1987–88. Net invisibles excluding private transfers showed a steady deterioration from a surplus of US$ 2,044.3 million (₹ 1,615 crore) in 1980–81 to a modest surplus of US$ 18.0 million (₹ 23 crore) in 1986–87 and turned into a deficit of US$ 792.1 million (₹ 1,027 crore) in 1987–88, a major reason being the persistent rise in interest payments on debt due to continued higher CAD.

The analysis showed that the large order of CAD in the Seventh Plan period had been financed partly by drawing down reserves, but mainly by a larger inflow of capital both on concessional terms and commercial terms and by way of NRI deposits. In addition, short-term debt of acceptance credits was quite substantial. India's total short, medium and long-term external debt, as well as NRI deposit liabilities as at end-March 1989, amounted to nearly US$ 60,062.1 million (₹ 86,970 crore), which worked out to 22.0 per cent of GDP or about 280.0 per cent of current receipts (exports plus invisible receipts) during 1988–89. By the end of the Seventh Plan, short, medium and long-term debt and NRI deposit liabilities were estimated to exceed a staggering US$ 6,009.6 million (₹ 1,00,000 crore). The Reserve Bank was categorical that the existing level of reserves of about US$ 3,383.4 million (₹ 5,630 crore) was 'very low' and worked out to barely 1.6 months of imports. The Reserve Bank emphasised that the country could not afford to lose any further reserves and must aim at rebuilding them to the equivalent of two to two-and-a-half months' imports in the Eighth Plan period. The Bank sounded a note of caution that the country's credit standing in the international markets might be adversely affected unless the CAD was quickly reduced in absolute terms. The prognosis communicated to the Government was:

> The large current account deficits can be financed by larger inflows of capital from abroad, by way of higher inflow of funds under FCNR(A) Scheme and larger utilisation of commercial borrowings. But this will add to debt burden and debt servicing liabilities. International bankers have already started raising questions in private conversations as to whether our debt servicing levels are not already excessive. Therefore, though we continue to raise commercial credit on competitive terms there is a clear and urgent need for caution. At the same time, it is important that we present a balanced view of our external account. Any impression of panic or serious deterioration would create doubts in the external financial markets, affect our credit standing and result in higher interest rates on new loans. The pressures on balance of payments can be contained only through a reduction in current account deficit in absolute terms as quickly as possible.

To arrest the deterioration in the invisibles account and thereby reduce the CAD, the Reserve Bank offered a number of recommendations, some of them having been already suggested to the Government. These included an improvement in the domestic fiscal balance by reducing the budget deficit, augmenting exportable surplus by limiting domestic consumption of some commodities, a closer examination of the import intensity of exports, containing imports in defence and bulk items, and a careful pruning of imports for which the Government was making the exchange allocation. The two new suggestions pertained to restraining domestic consumption of petroleum products and to further increasing earnings from tourism. However, the most pertinent and rather practical proposition was to augment foreign direct investment (FDI) as an alternative or supplement to external borrowings. Conceding that this was a 'sensitive' issue and tended to create apprehensions in some quarters, the Reserve Bank espoused the need to take a 'rational' view of the matter in light of pressures on the country's external account, the widespread interest that existed in investment in India provided the terms were attractive, the huge surpluses in countries like Japan and Germany, the high level of self-confidence that Indian industry had developed in partnering with foreign investors, and the urgent need for better technology and higher exports. In this context, the letter also noted the possibility of greater investment in Eastern Europe, where rapid political changes were under way to the detriment of Indian interests. The Reserve Bank emphasised, "There are thus important opportunities which could be gained or lost depending on what decisions we take on the issue at this crucial time." To attract substantial investments from abroad, the Governor expressed the view that some changes in the policies were necessary and in this regard the Government needed to address the following crucial issues: an increase in foreign holdings in new industries from 40.0 per cent to, say, 51.0 per cent, simplification and quickening of the procedures for such investment, and the need and justification for a more liberal mix of export obligation and sales in the domestic market.

WORSENING OF THE CRISIS TRIGGERED BY THE GULF WAR

Following the discussions between the Reserve Bank and the Government on August 13, 1990, regarding country's BoP situation, the Governor sent a detailed letter to the Finance Minister, dated August 16, 1990. After going over the main causes and effects of the rapidly deteriorating state of the BoP and the foreign currency reserves position with special focus on the impact of the gulf crisis on the economy, the letter reviewed the pattern of financing the looming CAD, namely, external assistance, commercial borrowings, NRI deposits and foreign exchange reserves.

The main conclusions of the review of the situation were that though the annual commitment of assistance was still quite high, most of it was tied to projects, actual utilisation was slow and doubts were expressed about whether donors would be prepared to provide quick disbursing, essentially BoP assistance. As regards commercial borrowings, international rating agencies had expressed concerns about India's rising debt and debt-service ratio and, in fact, Moody's had placed India on a watch list as a precursor to a possible downgrade of its credit rating. This meant that international banks would become more cautious in lending to India and the cost of borrowings would rise; already the margins over LIBOR had started moving up. NRI deposits, although a somewhat costlier source of external finance, had provided strong support to the country's BoP and were rising from year to year. These deposits were seen to be sensitive to the changing market perceptions about India and the Reserve Bank's assessment was that it would be too optimistic to assume a rising curve of net receipts on this account. The picture was also not bright in the case of acceptance credits; because of the rollover beyond 180 days, which had been estimated at nearly US$ 1.0 billion, the cost had gone up. The State Bank of India (SBI), which had raised most of this finance, was finding it difficult to substitute this credit with medium-term facilities. The commercial paper

(CP) market was becoming tighter and, with outstanding acceptance credits already on the higher side, the Reserve Bank felt that there might be limited scope for raising them further. Foreign exchange reserves having already declined to a low level, the Reserve Bank opined that it would be 'inadvisable' to allow them to fall further. The Reserve Bank suggested that it would be useful to revalue the gold assets held by the Reserve Bank closer to international prices by amending the Reserve Bank of India (RBI) Act, 1934. Also, to improve flexibility in the use of gold reserves, an idea was mooted that 15.0 per cent of the reserves might be kept outside India as already permitted under the Act. The extant position was thus summed up as that apart from the inevitable increase in the cost of commercial borrowings, there might also be some difficulty in obtaining increasing amounts of funds from foreign commercial banks to finance the CAD not covered by external assistance and NRI deposits.

The Reserve Bank offered a number of policy options in this letter to arrest the CAD, which was difficult to sustain. The prime and most important corrective action was seen in fiscal consolidation, *viz.*:

> There is need for a strong adjustment to restore viability of the balance of payments. In fact, such adjustment is overdue. The elements of the needed adjustments are well known. There has to be substantial fiscal consolidation through reduction of budget deficits, growth of liquidity has to be reined in, exports have to be increased still further, and a better balance brought about between exports and imports.

As the oil import bill accounted for a major strain on the BoP, the Reserve Bank advocated raising domestic prices to reflect import costs; this was expected to conserve energy use by restraining, in particular, consumption of oil and, to the extent feasible, increasing domestic production of oil.

On its part, the Reserve Bank suggested taking recourse to extraordinary financing from external sources to tide over the immediate situation, a strategy that was in fact eventually adopted. In the same letter, the Government was urged to take a policy decision to make the requisite adjustments with recourse to extraordinary financing (*e.g.*, from the IMF and/or under the fast-disbursing facilities of the World Bank). The desirability, advantages and disadvantages of such a method were persuasively expressed:

> The advantage of such extraordinary financing would be that adjustment will take place in a more orderly fashion and will be less disruptive of the growth process. Also, arrangements with the aforesaid multilateral institution/institutions will give the right signals to the financial markets and enhance the willingness of the banking community to lend more money to India. However, recourse to the IMF has political overtones and will involve strong conditionality. Such conditionality will, however, involve more or less similar measures that will have to be taken even if there is no recourse to the IMF. One important difference, however, could be that under a Fund programme tightening imports may be more difficult than would be the case otherwise. Adjustment without extraordinary financing will have to be much stronger implying substantial reduction in the current account deficit in a shorter span of time. Either way, the policy with regard to the exchange range of the rupee may not be different from what is being pursued at present.

The advice of the Reserve Bank to choose the option of approaching multilateral institutions to prevent the occurrence of the crisis was eventually followed. It was, however, for the Governor, Reserve Bank and the newly elected Government at the Centre to carry forward the immediate measures to contain the crisis and to undertake reform measures for sustained long-term growth with stability.

CONCLUDING OBSERVATIONS

The serious external payments crisis that struck in 1991 could be attributed mainly to the highly expansionary fiscal policy pursued since the mid-1980s that caused some serious distortions in macroeconomic management of both the domestic and external sectors. This was exacerbated by certain coincidental geopolitical developments. The early reform measures introduced from the mid-1980s were implemented without an overarching framework, resulting in the emergence of macroeconomic distortions. The fiscal deficit as a percentage of GDP enlarged to 9.4 per cent in 1990–91 as against the average of 6.3 per cent in the first half of the 1980s. A sizeable component of monetised deficit in the already large fiscal deficit resulted in rapid growth of monetary liquidity that was far out of alignment with real economic growth, thereby generating severe demand pressures and accelerating the pace of inflation. These imbalances, in turn, spilt over on to the external sector in the form of a large and unsustainable CAD. The persistently high level of fiscal deficit and CAD resulted in a sizeable increase in public debt, both domestic and external. There was a step-up in short-term commercial borrowings in 1988–89 and 1989–90. India was thus faced with large internal and external financial imbalances and was consequently vulnerable to adverse external shocks around 1990.

In 1990, two instant external shocks contributed to further widening of the CAD. The first was Iraq's invasion of Kuwait, which resulted in the return and rehabilitation of Indians working in that region. The gulf crisis had a serious impact on India's POL import bill, which increased over 50.0 per cent. The direct overall adverse impact of the gulf crisis, lasting for about seven months from August 1990 to February 1991, on the current account of India's BoP for the fiscal year 1990–91 was estimated at US$ 2,987.0 million. The gulf crisis had a significant adverse impact on the flow of remittances into India. By September 1990, the net inflow of NRI deposits had turned negative. Access to commercial borrowings became more expensive. The fall in capital inflows compounded the problem of financing the rising levels of the CAD. The second shock was slow economic growth in India's export markets. Further, India's export competitiveness was adversely affected by steady appreciation in the rupee's REER by 20.0 per cent between 1979 and 1986.

The country also faced intense political uncertainty during this period. Within a span of two years, *i.e.*, November 1989 and May 1991, there were three unstable governments at the Centre.

Rupee trade with the Soviet bloc was an important element of India's trade in the 1980s. During 1990–91, only three countries, *viz*., the USSR, Czechoslovakia and Romania settled their payments under the RPA. However, the trade was dominated by the USSR, which accounted for 95.0 per cent of the total trade with countries under the RPA. With the introduction of Glasnost and the breaking away of Eastern European countries, several rupee payment arrangements were terminated in 1990–91.

The changing composition of external debt, which shifted from official to commercial and towards the short-term, was another factor contributing to external imbalances. Besides long-term and medium-term debt, there was short-term debt in the nature of suppliers' credit and BAF. The downgrading of India's credit rating by international rating agencies prompted international banks to restrict the rollover facility. The share of external assistance in total debt declined. The hardening of terms for such assistance and the rise in the rate of interest contributed to bunching of debt-service payments. In 1990, there was a marked slowdown in borrowings from the international capital market. Creditworthiness considerations became of paramount importance and capital adequacy requirements constrained the lending activities of banks. Against this background, India's commercial borrowings in terms of commitments dropped sharply.

In November 1990, the Government lost a crucial vote of confidence in Parliament. The Union Budget due at the end of February 1991 was postponed and a vote on account was presented, which eroded the confidence of the international community in India's ability to steer through the crisis. By June 1991, the BoP crisis had become a crisis of confidence in Government's ability to manage the external sector situation, with a serious possibility of a default in its external payments.

Ever since 1988–89, the Reserve Bank had been continually alerting the Government regarding the adverse consequences of increasing government deficit, its impact on the external payments situation and the worsening BoP position. The Reserve Bank in its communication to the Government focused on policy measures, which were required to correct the situation, *i.e.*, export promotion, exchange rate policy and containment of the fiscal deficit of the Government. The analysis by the Reserve Bank showed that a large order of the CAD in the Seventh Plan period was financed partly by drawing down the reserves, but mainly by the larger inflow of capital on commercial terms. In addition, short-term debt was substantial. India's total short, medium and long-term external debt as well as NRI deposit liabilities at end-March 1989 worked out to 22.0 per cent of GDP or about 280.0 per cent of current receipts.

The crisis had assumed grave proportions when India was faced with the possibility of a default in external payments in June 1991. The Government and the Reserve Bank at official levels, amidst deep political uncertainties, took corrective steps with a resolve not seen any time before in India's economic history. The country, besides managing its BoP position, also embarked on a series of enduring macroeconomic and financial sector reforms.