12

Management and Resolution of the 1991 Crisis

INTRODUCTION

The experience with the onset of the balance of payments (BoP) crisis of 1991, the responses and reactions from both official and political circles, and the strategic decisions and action taken during the period 1990 to 1992 unfold an eventful story. The year 1991 is important not only because of the country's active engagement with the International Monetary Fund (IMF), but also because of the commitment with which the policymakers undertook long-term economic and financial sector reforms that had the potential to bring about a major structural break in India's growth trajectory and its integration with the global economy.

This chapter discusses serious dimensions of the crisis of 1991, the scope and content of the IMF programme that resulted in an arrangement of support, the actions taken by the Government in close co-ordination with the Reserve Bank and the roadmap for medium-term economic and financial sector reforms.

DIMENSIONS AND INTENSITY OF THE CRISIS

In 1990–91, a slowdown in world trade following the recessionary conditions in the industrialised countries and the economic disruption in Eastern Europe, including the USSR, began to affect India's exports during early 1990–91 and, in the face of rising imports, contributed to widening of the trade deficit. The trade deficit at US$ 9,437.0 million increased by US$ 1,981.0 million or 26.5 per cent over the previous year, *i.e.*, 1989–90. Net invisibles receipts turned negative to US$ (–)242.0 million from US$ 615.0

million, showing a decline of 139.5 per cent over the previous year. As a result, the current account deficit (CAD) showed a sharp increase of 41.5 per cent during 1990–91 over the previous year. The CAD as a proportion of gross domestic product (GDP) stood at (–) 3.0 per cent for the year.

Signs of the payments crisis became evident in the second half of 1990–91 when the gulf war led to a sharp increase in the oil prices. Foreign exchange reserves began to decline from September 1990. The reserves declined by 71.2 per cent between the end of August 1990 and January 16, 1991, from a level of US$ 3.1 billion to US$ 896.0 million.

CRISIS-RELATED DEVELOPMENTS IN 1990–91

The immediate cause for the loss of reserves beginning in September 1990 was a sharp rise in the import bill of oil. From an average of US$ 287.0 million per month in June–August 1990, the oil imports increased by 133.8 per cent to US$ 671.0 million per month in the ensuing six months. The world oil prices surged on annexation of Kuwait, and spot purchases made to prevent the emergence of shortages in the domestic market were very expensive. The effect of the rise in oil prices was aggravated by the events that followed. Indian workers employed in Kuwait had to be airlifted back to India and their remittances ceased to flow in. Further, the consequent UN trade embargo on Iraq led to the cessation of exports to Iraq and Kuwait. The loss of exports to West Asia was estimated at about US$ 280.0 million during 1990–91.

The payments crisis of 1991 was not, however, due simply to deterioration in the trade account; it was accompanied by other adverse developments on the capital account. Short-term credit had started drying up, thus imposing a severe strain on the BoP position. In 1989–90, canalising agencies increased their recourse to short-term credit. Such 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, but the cost rose to 0.65 per cent above LIBOR in March 1991, and to 1.25 per cent above LIBOR by May. By June, the overall cost of credit was far higher. Margins over LIBOR settled at 2.0 per cent.

DECLINE IN EXTERNAL COMMERCIAL BORROWINGS

The volume of external commercial borrowings (ECBs) abroad with maturity of over a year (and going up to 12 years) that was approved in the

3 years between 1989 and 1992 is shown in Table 12.1. The ECBs approved by the Government amounted to US$ 3,377.0 million in 1989–90. These came down by 42.2 per cent in 1990–91. In the first half of 1991–92, the volume of approved commercial borrowings further declined by 69.2 per cent. These loans were intended for financial institutions (FIs) and public sector enterprises to finance capital goods imports. They imparted flexibility to the funding pattern and facilitated cash management, and were relatively cheap as long as India's credit rating was good. The fall was accounted for by the bank loans, bonds placed abroad as well as the export credits. Though this period witnessed a decline in the overall availability of international credit due to tightening of Basel norms and uncertainty caused by the gulf crisis, in the case of India, the decline could be attributed primarily to the downgrade in its credit rating.

The outflow from non-resident Indian (NRI) deposits was also substantial. NRI deposits are effectively a form of short-term debt, because although they take the form of time deposits for different periods, the depositor could withdraw such deposits with some penalty and loss of interest. The outflow from NRI deposits amounted to US$ 952.0 million in April–June 1991, and continued at the monthly average rate of US$ 120.0 million in July–September and then at US$ 83.0 million in October–December. The trend was reversed only in January 1992.

TABLE 12.1

Approvals of External Commercial Borrowings

(US$ million)

	1989–90	*1990–91*	*April–Sept. l991*
Bank Loans	1,415 (2,296)	356 (624)	19 (50)
Bonds	751 (1,219)	660 (1,155)	–
Export Credits	1,209 (1,963)	934 (1,635)	582 (1,509)
Total	3,375 (5,479)	1,950 (3,414)	601 (1,559)

Notes: 1. Exchange rate of the Indian rupee taken at annual average of calendar year.
2. Figures in parentheses indicate rupees in crore.
3. '–': Nil.

Source: Government of India, *Economic Survey, 1991–92.*

FOREIGN EXCHANGE RESERVES 1990–91

The fiscal year 1990–91 and the first quarter (April–June) of 1991–92 witnessed a steep fall in the foreign exchange reserves due to a combination of adverse short-term factors, such as a surge in the POL import bill, continued erosion in net invisibles earnings, reduced access to international financial markets and lower inflows into non-resident deposit accounts. At the end of March 1990, India's foreign exchange reserves stood at a little below two months of import requirements. In addition, during the year, there were some special transactions. The amount of SDR 487 million in the reserve tranche of the IMF was drawn in three instalments on July 20, August 14 and September 4, 1990, and by the end of September 1990, the reserves had declined to SDR 2,523 million. With effect from October 17, 1990, gold holdings were revalued closer to the international market price as against the previous practice of ₹ 84.39 per 10 fine gms. During the quarter October–December 1990, excluding the revaluation, gold reserves recorded a drastic fall of SDR 1,080 million. The import cover of the reserves thus declined to three weeks of import value as at end-December 1990. As part of liquidity management, India negotiated with the IMF a drawal of SDR 717 million under the compensatory and contingency financing facility (CCFF) and SDR 552 million under the first credit tranche of its stand-by arrangement.

Excluding the revaluation of gold, the reserves rose by SDR 668 million during the last quarter of the financial year and amounted to SDR 2,111 million as at end-March 1991. This, however, resulted in an overall decline in reserves during the year to the extent of SDR 934 million. Inclusive of the revaluation of gold, the foreign exchange reserves amounted to SDR 4,329 million and SDR 3,564 million at the end of March 1991 and June 1991, respectively. The BoP position as at end-March 1991 and March 1992 *vis-à-vis* that of 1989–90 brings out the comparative deterioration in various components of the BoP and other indicators (Tables 12.2 and 12.3).

The rapid loss of reserves prompted the Government to take several short-term measures in the second half of 1990–91 to mitigate the adverse impact of the deteriorating reserves position. In October 1990, the Reserve Bank imposed a cash margin of 50.0 per cent on imports other than those of capital goods, which were allowed only against foreign sources of credit. In December 1990, the Government imposed a surcharge of 25.0 per cent on the prices of petroleum products, except domestic gas, and also raised

TABLE 12.2

Key Components of India's BoP

(US$ million)

	1989–90	*1990–91*	*1991–92*
Merchandise			
a. Exports (fob)	16,955	18,477	18,266
b. Imports (cif)	24,411	27,914	21,064
I. Trade Balance (a–b)	–7,456	–9,437	–2,798
II. Invisibles (Net)	615	–242	1,620
III. Current Account (I+II)	–6,841	–9,680	–1,178
IV. Capital Account (a to f)	6,977	7,188	3,777
a. Foreign Investment	410	103	133
b. External Assistance (net)	1,856	2,210	3,039
d. Commercial Borrowings (net)	1,777	2,248	1,456
e. Rupee Debt Service	--	– 1,193	–1,240
e. NRI Deposits (net)	2,403	1,536	290
f. Other Capital	531	2,284	101
V. Overall Balance (III + IV)	+136	–2,492	2,599
VI. Monetary Movements (VII+VIII+IX)	–136	2,492	–2,599
VII. Reserves (increase –/decrease +)	740	1,278	–3,384
VIII. IMF (Net)	–876	1,214	785
IX. SDR Allocation	0	0	0

Note: '--': Nil.

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2008–09.*

TABLE 12.3

BoP Indicators

(Per cent)

	1989–90	*1990–91*	*1991–92*
Trade			
Exports/GDP	5.8	5.8	6.9
Imports/GDP	8.3	8.8	7.9
Invisibles:			
Receipts/GDP	2.6	2.4	3.6
Payments/GDP	2.3	2.4	2.9
Net/GDP	0.2	–0.1	0.7
Current Account			
Current receipts/GDP	8.2	8.0	10.3
Current receipts/Current payments	76.4	71.5	94.3
CAD/GDP	–2.3	–3.0	–0.3
Capital Account			
Foreign investment/Export	2.4	0.6	0.7
Foreign investment/GDP	0.1	0.0	0.1
Import cover of reserves (in months)	1.9	2.5	5.3

Note: Capital account includes errors and omissions.

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2008–09.*

auxiliary customs duties. The cash margin imposed by the Reserve Bank was raised to 133.3 per cent in March 1991 and further to 200.0 per cent in April 1991. In May, the Reserve Bank imposed a 25.0 per cent surcharge on interest on bank credit for imports. These stringent measures brought about a considerable degree of import compression. Non-oil imports in October–December 1990 were 16.8 per cent higher in dollar terms than a year earlier. In the subsequent quarter, non-oil imports were 4.1 per cent below the level in the corresponding period of the previous year. In April–June 1991, these were 23.1 per cent lower in dollar terms. Details of various measures implemented by the Reserve Bank and the Government in close co-ordination, in an otherwise politically sensitive environment, are elaborated in the subsequent section, showing that the crisis was managed in a manner that was unprecedented in the economic history of the country.

To restore the competitiveness of Indian exports and reduce trade deficit and CAD, there were several downward adjustments to the rupee value from 1985. The exchange rate of the rupee was adjusted downwards sharply by about 18.0 per cent in two stages — on July 1 and July 3, 1991.[1] The dual exchange rate system introduced in March 1992 reduced the impact of exchange rate volatility. Further progress was made after an 11-month experience in favour of unifying the exchange rate. In addition, several structural measures were taken to move away from the conventional mechanism of import compression.

THE CRISIS SITUATION CONTINUED IN 1991–92

By June 1991, it was clear that import compression as an instrument for managing the BoP was proving to be counterproductive. The adverse impact of import compression can be gauged by comparing the import figures for April–September 1990–91 with those for 1991–92. Merchandise imports (in terms of US dollars) decreased by 17.5 per cent between April–September 1991–92 and April–September 1990–91. Essential imports consisting of oil and refined products, food grains, edible oils, fertilisers and non-ferrous metals fell by 17.2 per cent, while export-related imports slid down by 14.8 per cent. Of the rest, bulk imports — steel, coal, ores, paper and pulses — fell by 25.4 per cent, primarily on account of a conscious policy, and the rest by 32.8 per cent. The proportion of these residual goods in total imports declined to 13.5 per cent by April–September 1991; there

1. For details, refer to the section on crisis management in this chapter.

was not much room left for their compression. Further import reduction of such products would have meant a cutback in the availability of essential inputs in industry and transport, petroleum products and fertilisers. The adverse effect of import compression was felt in the decline in the index of industrial production (IIP) during 1991–92. Additional compression would have caused an even sharper fall in industrial production, disruption of transport and a fall in exports, as export-related imports would have shrunk. Thus, import compression had reached a stage where it could have caused widespread loss of production and employment.

The adverse developments in the capital account continued through 1991. While the trade deficit came down from US$ 781.0 million per month in October–December 1990 to US$ 382.0 million per month in January–March 1991 and further to US$ 172.0 million per month in April–June 1991, the outflow of foreign currency non-resident (FCNR) deposits accelerated from US$ 59.0 million a month in October–December 1990 to US$ 76.0 million in January–March 1991 and further to US$ 310.0 million in April–June 1991. There was also evidence that expectations of default, and therefore of sharp devaluation, were creating longer leads in the payments for imports and lags in the realisation of export proceeds, which exacerbated the foreign exchange shortage in the market.

On March 18, 1991, the Governor held prolonged discussions with the Finance Secretary on the BoP prospects in the ensuing months. The gist of the discussions was communicated to the Government on March 25, 1992, which presented a clear but grim picture of the BoP position. The Reserve Bank pointed out:

> The commercial banks were having serious difficulties in sustaining the level of their short term borrowings. The SBI was borrowing about 1.7 billion in the overnight market which had increased the cost of borrowing substantially. So far these funds were available, though at a high price. The SBI New York was also drawing funds from their overseas branches in London, Paris and Frankfurt. The availability of credit had however become more difficult as some international commercial banks had withdrawn the lines of credit to SBI New York. In order to support SBI and the overseas branches, RBI had transferred $250 million to SBI New York and about $80 million to UCO Bank. Further support was required by the overseas branches of Indian Banks.

The Reserve Bank further explained that the BoP prospects were bleak and the possibility of getting more funds from international banks was not bright. The Governor informed the Government that although the Federal Reserve Bank of New York had assured that they would extend all possible support to the Indian banks, since then some international banks had, in fact, withdrawn their support to the State Bank of India (SBI). The Governor did not support suspending imports under the open general licence (OGL), but favoured restricting imports through credit control. In view of the precarious situation, it was agreed that it was both necessary and desirable to restrict import demand by increasing the requirement for credit margins for all imports and that the Reserve Bank would work out the guidelines based on the discussions.[2]

The analysis of the BoP data during 1991–92 indicated that there was a sharp contraction in the merchandise trade deficit as compared with 1990–91, largely due to a massive reduction in imports. Invisibles were higher by 10.3 per cent compared with a decline of 8.6 per cent during the preceding year. Due to accruals of US$ 863.0 million under the foreign exchange (immunities) scheme, 1991, private transfer receipts during 1991–92 showed an increase, though other remittances from NRIs working abroad, which were a major component of private transfers, were estimated to be at the same level as in the preceding year. Interest payments, as well as outward remittances for royalties and technical know-how continued to show an increase. Nevertheless, essentially as a result of the drastic cut-back in the trade deficit, the CAD was compressed by 87.8 per cent during 1991–92 over the preceding year.

The capital account was characterised by mobilisation of funds from NRIs and larger assistance from bilateral and multilateral donors. During the year, there was an outflow of US$ 1,627.0 million under the FCNR (A) scheme as against an inflow of US$ 168.0 million during 1990–91 and the bulk of these outflows, amounting to nearly US$ 1 billion, occurred during April–June 1991 — a period of overall uncertainty. With some rapid measures of stabilisation, the outflows tapered down to US$ 152.0 million in the last quarter of the year 1991–92, which seemed to represent portfolio switches in favour of other schemes. Non-resident (external) rupee [NR(E)R] deposits also suffered, although marginally, showing an outflow of about US$ 90.0 million during April–December, 1991 against

2. D.O. letter of the Finance Secretary, No. 47/FS/91-TS dated March 25, 1991.

an inflow of US$ 30.0 million in the same period in the previous year. As a result, the total outstanding balances under these two accounts put together declined from US$ 10.6 billion at end-March 1991 to US$ 8.5 billion at end-December 1991 (Table 12.4).

TABLE 12.4

Stocks and Flows under Non-Resident Deposit Accounts

(US$ billion)

Year	*NR(E)R Accounts*		*FCNR Accounts*		*Total*	
	Outstanding at year end@	*Inflow((+)/ Outflow(–)*	*Outstanding at year end***	*Inflow((+)/ Outflow(–)*	*Outstanding at year end@*	*Inflow((+)/ Outflow(–)*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*
1985–86	2.8	0.5	1.8	0.9	4.6	1.4
1986–87	3.3	0.4	2.7	0.9	6.1	1.3
1987–88	3.9	0.4	3.8	1.0	7.8	1.4
1988–89	3.8	0.2	5.3	1.5	9.0	1.7
1989–90	3.8	-	6.6	1.3	10.4	1.3
1990–91	3.7	0.1	6.8	0.1	10.6	0.2
1991–92*	3.0	–0.1	5.5	–1.5	8.5	–1.6

Notes: @ Inclusive of accrued interest.
* Up to December 31, 1991 and provisional.
** Exclusive of accrued interest.
'-' Nil.

Source: Government of India, *Economic Survey, 1991–92.*

The large outflow under the FCNR (A) scheme was, however, recouped to a great extent by subscription to India development bonds (IDBs) aggregating US$ 1,627.0 million. The IDBs had the added advantage of elongated maturities. The utilisation of external assistance, excluding exceptional financing of US$ 1.0 billion from the World Bank, the Asian Development Bank (ADB) and Japan, was at the same level as in 1990–91. Commercial borrowings other than the IDBs were significantly lower during the year due to India's downgraded rating by rating agencies.

The Aid-India Consortium committed aid during 1991–92 amounting to US$ 6.7 billion for India, of which US$ 2.3 billion could be drawn immediately. At this crucial stage, on October 31, 1991, the IMF approved an upper credit tranche stand-by arrangement amounting to SDR 1,656 million (US$ 2.2 billion), which was to be availed of in instalments over 20 months from the date of approval. The first instalment of SDR 85 million (US$ 117.0 million) was drawn in November 1991 and the second

instalment of SDR 185 million (US$ 263.6 million) in January 1992. In July 1992, there was a drawal of a third instalment of SDR 462 million (US$ 663.0 million).

FOREIGN EXCHANGE RESERVES 1991–92

India's foreign exchange reserves rose from US$ 5,834.0 million at end-March 1991 to US$ 9,220.0 million at end-March 1992, reflecting a distinct easing of foreign exchange constraints (Table 12.5).

TABLE 12.5

Foreign Exchange Reserves

(US$ million)

End of Financial Year	*SDR*	*Gold*	*FCA*	*Total*
1989–90	107	487	3,368	3,962
1990–91	102	3,496	2,236	5,834
1991–92	90	3,499	5,631	9,220

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2008–09.*

EXTERNAL DEBT

With the gradually growing deficit in the current account, India's external debt liabilities comprising multilateral and bilateral assistance, commercial borrowings and NRI deposits rose over the years. India's medium and long-term debt, *i.e.*, with the original maturity of more than one year and excluding NRI deposits, increased from US$ 47.0 billion at end-March 1990 to US$ 51.7 billion at end-March 1991 and further to US$ 57.6 billion at end-March 1992, showing an increase of 10.0 per cent and 11.4 per cent, respectively over the corresponding previous years. Including NRI deposits of all maturities and short-term debt in the nature of trade credit, suppliers' credit and credit under bankers' acceptance facility (BAF), India's external debt liabilities as at end-March 1991 stood at US$ 67.1 billion, which increased to US$ 68.8 billion at end-March 1992. The increase in rupee terms was much larger, which could be attributed to a downward adjustment of the rupee *vis-à-vis* major currencies in July 1991 and the introduction of liberalised exchange rate management system (LERMS) in March 1992.

In relation to GDP at current market prices, the medium and long-term external debt and NRI deposits rose to 31.2 per cent at end-March

1992 as against 23.4 per cent at end-March 1991, reflecting the depreciation of the rupee. The debt-to-exports ratio was around 259.0 per cent at end-March 1991 and rose to about 303.0 per cent at end-March 1992. The debt-service ratio, *i.e.*, ratio of debt-service payments to current receipts excluding official transfers, declined to 30.2 per cent during 1991–92 from 35.3 per cent in 1990–91.

The gulf crisis and a downgrade in India's credit rating below the investment grade prevented India from accessing international markets for funds. This also resulted in net outflows on account of ECBs both in 1990–91 and 1991–92 (Table 12.6).

TABLE 12.6

External Commercial Borrowings

(US$ billion)

	1987–88	*1988–89*	*1989–90*	*1990–91*	*1991–92*	*1992 April–December*
I. Authorisation	2.05	2.98	3.29	1.90	2.13	1.59
II. Gross Disbursements	1.74	2.81	2.52	1.70	1.10	0.55
III. Debt-Service Payments	1.34	1.54	1.83	2.23	2.18	1.01
a. Amortisation	0.67	0.76	0.87	1.19	1.17	0.60
b. Interest payment	0.67	0.77	0.95	1.04	1.01	0.41
IV. Net Capital Inflows (II–IIIa)	1.07	2.05	1.65	0.51	–0.07	–0.05
V. Net Transfers (II–III)	0.40	1.27	0.69	–0.53	–1.08	–0.46

Note: ECBs include long-term loans from commercial banks, other FIs, bonds and floating rate notes, suppliers' credit, buyer's credit, and credits from export credit agencies of concerned Governments, International Finance Corporation (IFC) (W) and private sector borrowings from ADB.

Source: Government of India, *Economic Survey, 1992–93.*

The crisis led to a situation where international markets did not open up on a normal note for Indian borrowers to take recourse to such borrowings on a significant scale. Moreover, the Government had decided to reduce the share of short-term borrowings in total debt. Consequently, a major portion of the commercial borrowings raised during the two years (1990–1992) was by way of export credits supported by official export credit agencies, such as the US Export-Import Bank and the Export Credit Guarantee Corporation (ECGC) of the UK.

THE ADJUSTMENT PROCESS AND ALTERNATIVE OPTIONS

At a critical time and in the thick of the BoP crisis, the main task of the Reserve Bank under the leadership of the Governor, Shri S. Venkitaramanan, turned out to navigate the country through the troubled waters. After successfully resolving the BoP crisis, the Reserve Bank had to address issues related to an unexpected breakout of irregularities in securities transactions from April 1992.

The adjustment process was complicated partly because of possible adverse public opinion and the consequent political overtones, and to some extent due to the absence of a stable Government. The official and political circles, however, considered several options from time to time and tried to wade through the crisis till a wide-ranging programme of stabilisation and structural adjustment was signed with the IMF in the late 1991. There is evidence that the country's authorities maintained close liaison with the IMF and the World Bank all along when drawals of funds were made from these institutions. The IMF programme of 1991 was a natural culmination of this ongoing co-operation between the country's authorities and the IMF. The various options that were considered and dropped or partially implemented to avert the crisis are summarised below.

In 1991, with the foreign exchange reserves dwindling, the Government and the Reserve Bank had four options. The first was to default on the country's external obligations. This action would have been self-defeating given that since December 1990, India had been borrowing on a daily basis and, as a result, market confidence had eroded. A default would not have been a strategic act of hard bargaining; rather, it would have destroyed any remaining credibility. India had a history of repaying its debts on time and policymakers did not want to sour that record. For a country that respected its national sovereignty, a default would have left it completely dependent on international institutions and creditors.

The second option was to seek private funds from abroad. However, commercial borrowings had dried up and NRIs were withdrawing their deposits; there was, in relative terms, a massive net outflow of US$ 1.3 billion from such accounts during April–September 1991. Seeking further support from this source was neither a feasible nor a realistic option.

The third option was to use gold reserves as an emergency measure. In April 1991, the Government raised US$ 200.0 million from the Union Bank of Switzerland (UBS) through a sale (with a repurchase option) of

20 tonnes of gold confiscated from smugglers. Again, in July 1991, India shipped 47 tonnes of gold to the Bank of England (BoE) to raise another US$ 405.0 million. This action helped the country repay its international donors and creditors, though it was not sufficient to completely absolve the country of the crisis.

The fourth option entailed seeking emergency bilateral assistance. Such assistance came in from Germany (US$ 60.0 million) and Japan (US$ 300.0 million). India's problem, however, was not merely the amount needed to avoid a default, but getting away fast from recurring liquidity squeezes. Additional measures were, therefore, needed.

In view of the overvaluation of the rupee in the later part of the 1980s *vis-à-vis* its Asian counterparts and the loss of competitiveness, devaluation, however unpopular, became necessary. In June 1991, the Finance Minister with his vast experience in the Government and at the Reserve Bank felt that making exchange rate adjustments, pursuing fiscal reforms and influencing business expectations were the most immediate and necessary policy responses. To minimise political opposition and institutional constraints, the Government implemented the devaluation policy in two steps through the Reserve Bank, which agreed to announce new intervention rates. The Reserve Bank had been intervening to stabilise the fall in the rupee value since 1987, so a lower rate of intervention signalled that the Government was willing to let the rupee fall further.

The devaluation took place in two steps. On July 1, 1991, the Finance Minister wanted to 'test the waters' before effecting any large change in the value of the rupee. Only when the markets reacted positively, a second devaluation was permitted on July 3, 1991. The two-step downward adjustment in the value of the rupee worked out to 17.38 per cent in terms of the intervention currency *i.e.*, pound sterling and about 18.7 per cent in US dollar terms. Further, to counteract any inflationary impact, the Bank increased the Bank Rate, term deposit rates and the lending rate for large borrowers.

Devaluation was an emergency measure and needed political tact. What mattered in 1991 were the follow-up policies and the people who executed them. The crisis gave policymakers the opportunity to pursue liberalisation, which the economic administration of the Government had been pushing for since the late 1980s. Industrial licensing for all, except 18 industries was abolished; investment caps on large industrial houses were removed; only six industries remained exclusively in the public sector;

access to foreign technology was liberalised; import licensing was virtually abolished; import duties were sharply reduced; and exporters could open foreign currency accounts.

An important dimension to the entire process of adjustment was the role played by the government administration in carrying through the measures in co-ordination with the Reserve Bank during a period of considerable political uncertainty. The authorities also maintained good working relationships with the multilateral institutions. This environment, in no small measure, helped in the effective co-ordination of domestic policymakers with the IMF and the World Bank, in instituting necessary reforms and eventually in the smooth conclusion of the programme once a regular Government was formed in June 1991. The IMF history stated:[3]

> The politics of borrowing from the IMF is always complex, but in India it was especially so. On the one hand, Indian politicians had long viewed IMF conditionality with some disdain. As soon as it became known that the government was applying for a stand-by arrangement, its leaders would be attacked in Parliament and in the press for subjugating the country's interests to foreign domination. On the other hand, most of the countries' economic and financial officials had good relations with the IMF, and an unusually high degree of trust had developed on both sides over the years.

The history further added:[4]

> The working relationship was a little unusual, in that the authorities knew full well what they needed to do to qualify for the Fund's seal of approval and financial support. The decision to devalue, for example, was not made at the insistence of the Fund, but on the understanding that the Fund would approve it and that both sides believed it was necessary and was in India's interest. As had been true for the 1981 negotiations, these discussions were amicable and collegial.

3. Boughton, James M. (2012). "Tearing Down Walls", *History of the International Monetary Fund 1990–1999*. International Monetary Fund.

4. Ibid.

THE IMF PROGRAMME: 1991–1993

STRATEGY AND KEY OBJECTIVES

In financial terms, the IMF's assistance was small compared with the dimensions of the crisis. In 1991–92, the withdrawals from the IMF amounted to US$ 1.2 billion as against India's short-term debt of US$ 6.0 billion at the end of 1990–91, with overnight borrowing in international capital markets of the order of US$ 2.0 billion. India's decision to seek assistance from the IMF perhaps came a trifle late. The previous two short-lived governments, in fact, gave enough evidence of the concerns about the BoP crisis and their drawal of reserves to finance the high fiscal deficit.[5] The Governor's letter to the Government in late 1989 and early 1990 clearly hinted at the possibility of approaching multinational institutions. However, the elections due in November, which were postponed, seemed to be the main reason why negotiators could not make commitments back then.

The IMF's support for the ongoing reforms gave international credibility to the Government in power. The Government had already taken steps to compress imports through higher cash margin requirements, surcharges on petroleum products and on interest on import credit, and tightened import licensing. There was also an urgent need to bring about medium-term structural adjustment to shift resources from the non-traded to the traded goods sector; promote exports; liberalise imports; and reduce state intervention in economic activity and the scope of the public sector. The prevalent view was that the economic policy had to undergo a transition from a regime of quantitative restrictions to a price-based mechanism with less state control, but in a gradual manner.

Under the CCFF agreement, India had withdrawn US$ 221.0 million and US$ 637.0 million in July and September 1991, respectively. With more wide-ranging reforms on the anvil, additional support was sought. The Reserve Bank in its Annual Report for 1990–91 explained that the

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5. The Finance Minister stated in his budget speech (February 1990) that "the fiscal imbalance [was] the root cause of the twin problems of inflation and the difficult [BoP] position". A year later, the Finance Minister admitted that the Government had realised the economic situation was one of 'crisis proportions' by November 1990 itself. Between July and September 1990, the National Front Government drew US$ 660.0 million from its reserve tranche in the IMF. By end-1990, when reserves could cover only three weeks of imports, India negotiated the purchase of US$ 1.8 billion under the IMF's CCFF (to cover oil imports) and the first tranche of a stand-by arrangement. The CCFF was an emergency measure and had very low conditionality attached to it.

stabilisation measures would take time to have an effect on foreign exchange reserves. It estimated that external financing of US$ 3.0 billion was needed in 1991–92 to 'undertake reforms without undue disruption'. India's letter of intent to the IMF outlined the requirements of external financing as well as India's proposals for further policy reforms.

The Finance Minister in the budget speech of 1992–93 allayed public fears about compromising national interests by depending on the IMF assistance and subjecting the country to certain conditionalities in the following manner, which corroborated the home-grown nature of the intended reforms:

> It has been alleged by some people that the reform programme has been dictated by the IMF and the World Bank. We are founder members of these two institutions and it is our right to borrow from them when we need assistance in support of our programmes. As lenders, they are required to satisfy themselves about our capacity to repay loans and this is where conditionality comes into the picture. All borrowing countries hold discussions with these institutions on the viability of the programmes for which assistance is sought. We have also held such discussions. The extent of conditionality depends on the amount and the type of assistance sought. However, I wish to state categorically that the conditions we have accepted reflect no more than the implementation of the reform programme as outlined in my letters of intent sent to the IMF and the World Bank, and are wholly consistent with our national interests. The bulk of the reform programme is based on the election manifesto of our Party. There is no question of the Government ever compromising our national interests, not to speak of our sovereignty.

In the November 1991 stand-by arrangement, the IMF promised to provide US$ 2.2 billion over a period of 20 months, with a comprehensive set of performance criteria and structural benchmarks to be achieved by May 1993. Both sides also expected that this arrangement would have to be followed by concessional loans under the enhanced structural adjustment facility (ESAF), but this did not materialise. In addition, the Aid-India Consortium committed US$ 6.7 billion in aid to India.

There was no extension of the IMF stand-by arrangement beyond 1993. There were, of course, positive signs in the economy: foreign

exchange reserves had climbed to US$ 9.8 billion by the end of 1992–93 and economic growth had recovered to 4.0 per cent.

KEY MACROECONOMIC OBJECTIVES AND STRUCTURAL BENCHMARKS

The key macroeconomic objectives of the programme included an easing of the payments situation and the rebuilding of gross international reserves to over 1.5 months of imports by the end of 1992–93; economic growth of 3.0–3.5 per cent in 1991–92 followed by a gradual recovery in 1992–93; and a reduction in inflation to no more than 6.0 per cent by the end of 1992–93. Taking account of the sizeable new investments and related imports needed to support the restructuring of the economy, the CAD was targeted at about 2.5 per cent of GDP in 1991–92 and 1992–93. A decline in the surplus of private savings over private investment was expected, as the latter would respond to the new opportunities stemming from structural reforms. The private savings rate was also anticipated to temporarily decline as a result of the dip in economic growth and the fiscal adjustment measures. Thus, the targeted reduction in the overall public sector deficit was considerably larger than the projected adjustment in the external current account.

FISCAL CONSOLIDATION

The medium-term objective was to reduce the public sector deficit from an estimated 12.5 per cent of GDP in 1990–91 to 8.5 per cent of GDP by 1992–93 and further to 7.0 per cent by the mid–1990s.

The fiscal programme for 1992–93 had the dual objective of continuing deficit reduction while simultaneously initiating major tax reforms. Further, substantial expenditure reductions were needed; the items being considered included a curtailment in the government wage bill, a further cutback in defence spending, a continued reduction in transfers to public enterprises, and a further reduction in fertiliser and food subsidies through additional price increases and better targeting.

Since the time between the elections and the July 1991 budget was too brief to formulate comprehensive proposals, the Government had committed itself to a fundamental tax reform to remedy these deficiencies, while mobilising additional revenues to compensate for the revenue loss from tariff reduction and to support the programmed fiscal adjustment. A tax reform committee was appointed that was to report in time for the

first stage of reforms to be incorporated in the 1992–93 budget; technical assistance was also requested from the IMF.

OTHER PUBLIC SECTORS

Beginning in 1992–93, the authorities intended to reduce statutory liquidity ratio (SLR) imposed on commercial banks to ensure that the reduced borrowing requirements of the Government did not provide scope for increased bank borrowings by the states. Other borrowings were also to be contained; in particular, the interest rates paid on the Government's small savings schemes (from which three-quarter of the proceeds were automatically on lent to the states) were to be kept under close review to ensure that these schemes did not draw funds away from commercial bank deposits.

With regard to public sector enterprises, the priority in the reforms programme was to eliminate structural rigidities and inefficiencies and to ensure that investments faced a market test. The central public enterprises deficit was targeted to decline to 3.0 per cent of GDP in 1991–92 from 3.5 per cent in 1990–91, partly as a result of reduced capital spending.

In contrast to central public enterprises, which generated internal resources to help finance investments, the state public enterprises incurred losses on a net after-tax basis and the bulk of these losses stemmed from the operations of the state electricity boards (SEBs), reflecting a non-commercial orientation and uneconomic pricing, especially for rural consumers. Losses by the SEBs contributed to arrears in their payments to power generation companies. To address these issues, the Central Government was pursuing three initiatives. First, a portion of central transfers to the states were earmarked for direct payment to power generation companies to address the problem of arrears. Second, a uniform minimum electricity tariff for agricultural consumers was proposed. Third, the Central Government no longer contributed to state power projects that did not meet minimum financial criteria.

MONETARY POLICY

Monetary policy was tightened progressively in 1991–92 in response to the external liquidity crisis and the build-up of inflationary pressures. The tightening was achieved through a combination of indirect instruments that operated with an effect on bank liquidity and interest rates (including the introduction of a 10.0% incremental cash reserve ratio and several

increases in administered interest rates) and more direct instruments (including a reduction in incremental credit-to-deposit ratios and a tightening of various directed credit and refinance facilities). In addition, the imposition of high cash margin requirements on import letters of credit (LCs) contributed to tighter domestic credit conditions.

The financial programme provided for continued monetary tightening. The targeted reduction in broad money growth to 13.0 per cent in 1991–92 and 11.0–12.0 per cent in 1992–93 was consistent with the output and inflation targets of the programme and conservative assumptions about demand for money; specifically, the targets assumed a broadly unchanged velocity of money compared with the trend decline observed during the preceding years.

To encourage increased reliance on market-based instruments of monetary control, the monetary performance criteria were set to be achieved by the Reserve Bank. The targets for net domestic assets were established to be consistent with the external objectives of the programme and provided for adequate growth in credit to the commercial sector. Monetary policy was expected to defend the external reserves position, and tighten further if net international reserves fell below the targeted floors.

The interest rates were progressively liberalised after the effective decontrol of rates charged on bank loans to non-preferred sectors in the late 1989. The ceiling on long-term loan rates charged by development banks and the restrictions on private debenture interest rates were both eliminated in July 1991. Since this substantially raised the borrowing costs of public sector enterprises closer to market rates, it was expected to significantly reduce their borrowing. However, interest rates on deposits and on the preferred sector credits (almost half the total) remained subject to controls.

Deposit rates were increased by 1.0 percentage point in July (to a range of 9.0–13.0%), but rates were negative in real terms. Thus, to implement the tight monetary policy, the Reserve Bank relied primarily on a selective tightening of credit rather than on further increases in interest rates, especially for deposits. The Reserve Bank noted that household financial savings were already buoyant at the prevailing interest rates. The IMF viewed that under the prevailing conditions, the level of domestic deposit rates could have a significant influence on the external account. Readiness to adopt timely and decisive action on all interest rates was, therefore, an important element of the financial strategy, both to make the commitment to exchange rate stability credible and to prevent the burden

of monetary tightness from falling disproportionately on sectors that did not have access to preferential credit. The Reserve Bank indicated that further increases in deposit interest rates would be implemented in early October 1991.

EXTERNAL SECTOR

The policymakers reaffirmed their commitment to maintaining the unblemished payments record of India. Hence, the external policy response to the deteriorating liquidity position consisted of: (i) a substantial exchange rate depreciation combined with the elimination of cash export subsidies designed to improve and make export incentives more uniform; (ii) the initiation of fundamental reforms to integrate India more closely with the world economy; and (iii) the temporary implementation, beginning in September 1990, of several special import compression measures.

The exchange rate of the rupee depreciated cumulatively by 60.0 per cent in nominal effective terms and by 50.0 per cent in real effective terms from January 1985 to June 1991. Following the July 1991 depreciation, the Government and the Reserve Bank announced their intention to hold the nominal effective exchange rate (NEER) stable in order to maintain confidence. Thus, tight financial policies were the primary means of maintaining competitiveness. Since inflation during the programme period was projected to be higher than in the partner countries, partly as a result of administered price increases and the lagged effects of the exchange rate action, a moderate real appreciation of the rupee was expected. However, the real effective rate was expected to remain well below its pre-July level. The IMF agreed that nominal exchange rate stability would be an important part of the strategy to restore internal and external confidence and to reduce inflation. To be credible, however, such a policy had to be backed by decisive financial policies; in particular, a much more active use of interest rate policy was needed.

STRUCTURAL REFORMS

The objective of the reforms was to promote economic growth by reducing government intervention, enhancing domestic competition, and accelerating India's integration with the world economy. The Government had already made significant policy changes in several key areas. Specific policy actions in a number of areas — notably industrial deregulation, trade policy, public enterprise reforms, and some aspects of financial sector

reforms — were also the basis for a World Bank structural adjustment loan (SAL), as well as sector loans. A number of measures were announced to strengthen competition between the private sector and public enterprises, where *de facto* monopoly power and soft budget constraints had been the root causes of inefficiency. Specifically, the number of industries reserved exclusively for the public sector was narrowed down to eight (relating to defence production, atomic energy, minerals and railways); the system of monitoring public enterprises was strengthened; the budget constraints faced by the enterprises were hardened through a reduction in transfers and subsidies from the Union Budget; and the Government announced its intention to sell up to 20.0 per cent of equity in selected public enterprises to mutual funds during 1991–92.

TRADE

The Government intended to substantively dismantle the quantitative restrictions on international trade over the next three to five years, moving to a transparent price-based system with moderate protection for domestic industry. The initial steps in this direction were taken in July 1991 with the abolition of cash export subsidies, modest reductions in peak tariff rates, a halt to new phased manufacturing programmes, and partial substitution of quantitative import restrictions by a tradable import entitlement — the Exim scrip. The intention was to use the latter scheme as a transitional vehicle for further import liberalisation: the list of eligible imports was to be gradually expanded, along with a phased increase in the Exim scrip entitlement rate.

FINANCIAL SECTOR

There were three priority areas for financial sector reform. First, a more market-oriented allocation of credit was required. The fiscal consolidation would reduce the share of total lending that was pre-empted by the public sector, but needed to be accompanied by a scaling-back in the scope of preferred sector lending. Second, a number of banks were in a weak financial position, and a detailed programme to strengthen their capital base and improve the supervision procedures was needed. The Government and the Reserve Bank regarded action in both these areas as essential pre-requisites for further interest rate liberalisation; in particular, the heavy implicit taxation of financial intermediation and the fragile financial position of some banks had constrained the deregulation of bank

deposit rates. The IMF provided technical assistance in the area of bank supervision. The third priority area related to the strengthening of capital markets, including the term-lending institutions. A high level committee chaired by Shri M. Narasimham was asked to submit detailed proposals in all these areas by November 1991.

There were substantial restrictions on closure, relocation, and the shedding of labour in both public and private industry. It was agreed to formulate a suitable policy framework to facilitate industrial restructuring, but noted that success would require the building of a political consensus. Nevertheless, two key components of the policy framework were put in place. First, the Board for Industrial and Financial Reconstruction (BIFR), established in 1987 to formulate rationalisation programmes for ailing private sector firms, was to be strengthened; its scope had already been widened to include public sector units. Second, a social safety net — the national renewal fund (NRF) — was established in the budget for 1991–92 to provide compensation and, more importantly, training for retrenched workers.

PERFORMANCE CRITERIA AND REVIEWS

The fiscal objectives of the programme were monitored through quarterly ceilings on the overall borrowing requirement of the Union Government as well as an indicative benchmark on total bank credit to the general government sector. In addition, implementation of additional expenditure and revenue measures was set out as the performance criterion for December 1991. The monetary objectives were supervised through ceilings on net domestic assets with a sub-ceiling on Reserve Bank credit to the Union Government. The external objectives were examined through quarterly floors on net international reserves of the Reserve Bank; there was also the performance criterion regarding the exchange and trade system. Quantitative performance criteria were set through March 1992, with annual indicative targets for fiscal 1992–93. The drawals under the stand-by arrangement are shown in Table 12.7.

A number of structural benchmarks in the areas of industrial policy, trade liberalisation, domestic pricing policies, public enterprise reforms, financial sector reforms, tax reforms, and expenditure control were also established. In particular, arriving at a mutual understanding in the last two areas as well as on the 1991–92 budget formed an important condition.

TABLE 12.7

Drawings under IMF Stand-by Arrangement 1991–1993

(US$ million)

Month/Year	*Amount*
November 1991	117.0
January 1992	263.6
July 1992	663.0
December 1992	643.0
February 1993	319.0
June 1993	325.0

Source: Reserve Bank of India, *Annual Report, 1991–92*; *1992–93*.

OVERALL ASSESSMENT

The 1993–94 budget speech of the Finance Minister provided a succinct assessment of the IMF programme and the Government's intention to carry forward the reforms in the coming years:

> It is now twenty months since our government took office: twenty eventful months in which we have worked ceaselessly to overcome the very difficult economic situation we inherited.
>
> The sense of crisis is now behind us. We have restored a measure of normalcy to our external payments. The annual rate of inflation has been reduced from the peak of 17% in August, 1991 to below 7%. International confidence has been restored. Agriculture has performed well in the current year and industrial production is beginning to recover. The growth of the economy, which had declined to 1.2% in 1991–92, is expected to be around 4% in 1992–93. The economic strategy we have followed, resting on the twin pillars of fiscal discipline and structural reform, has been vindicated by the decisive upturn.
>
> We have made good progress by reducing the fiscal deficit from 8.4% of GDP in 1990–91 to about 5% in the current year.
>
> Although the rupee has been floated for most current account transactions, the market exchange rate has remained relatively stable. The investment climate has improved considerably. Corporate capital issues by non-Government public limited

> companies in April–October 1992 were 67 percent higher than in the same period of the previous year. Loans sanctioned by financial institutions in the first ten months of 1992–93 were 49% higher than in the same period of the previous year. Foreign investors are showing active interest in investment in many sectors, including critical infrastructure sectors such as power and petroleum. Since August 1991 the approvals given for foreign investment proposals up to the end of January amount to an equity investment of $2.3 billion. These are of course only approvals at this stage and actual flows will take time to materialise, but they certainly indicate a substantial potential for larger investment inflows in the future.

As regards the success of the IMF programme, the history of the IMF stated:[6]

> The 1991–93 stand-by arrangement with India proved to be an outstanding success story, both for the Indian government and for the IMF. Faced with a dangerous fiscal and political crisis, Rao's government seized the opportunity to begin a reform program that irreversibly altered the very nature of the Indian economy. Although by all accounts the reform agenda was still far from being completed, it continued throughout the decade, and it enabled the Indian economy to weather the turbulence in the world financial system in the late 1990s. In 2003, India became a creditor of the Fund. Through the end of that decade, it did not have to borrow.

CRISIS MANAGEMENT: MEASURES ADOPTED DURING 1990–91 TO 1992–93

There are a few measures that need to be spelt out in detail to appreciate the extent of crisis management in 1990–91 through 1992–93. There was no particular roadmap for these reforms. The measures were initiated by the Reserve Bank in consultation with the Government or on its own as responses to the evolving situation and drew, *inter alia,* on cross-country international developments and experience.

The first was the matter of gold revaluation. Until the 1990s, the gold held by the Reserve Bank as part of the country's foreign exchange reserves

6. Ibid.

was valued at the rate of 0.118489 gms of fine gold per rupee (₹ 84.396 for 10 gms) as per section 33(4) of the Reserve Bank of India (RBI) Act, 1934. However, this rate was well below domestic and international prices. On September 3, 1990, the domestic price of gold was ₹ 3,372 for 10 gms, while the London Metal Exchange (LME) price, a standard indicator of international price, was ₹ 2,180 for 10 gms. The Reserve Bank valuation was about 1/40th of the domestic price and 1/26th of the international price. The value of gold held by the Bank under the different rates is given in Table 12.8.

TABLE 12.8

Gold Value

	Rate ₹ */10 gms*	*Value* ₹ *crore*
RBI	84.39	280.67
LME (as on September 3, 1990)	2,180	7,250.67
Domestic	3,372	11,214.02

Source: Reserve Bank of India, Department of External Investments and Operations.

The price adopted for valuation of gold in relation to the international price by the central banks varied widely across countries, with a few overvaluing and many undervaluing. Table 12.9 gives the details in this regard for select countries. The extent of undervaluation in the case of India was not only large compared with the international price but also *vis-à-vis* other developing countries.

It was viewed that revaluation of the gold holdings from time to time in accordance with international price movements could present a more realistic picture of India's foreign exchange reserves, particularly when making inter-country comparisons. Under the extant system, the flexibility for such periodic revaluation was limited as it called for an amendment to the RBI Act. Such a legislative process was time-consuming, whereas the Reserve Bank needed to respond quickly in such situations. To overcome this problem, the Ministry of Finance proposed[7] to amend section 33(4) of the RBI Act to allow for flexibility in periodic revaluation of gold.

7. D.O. Dy. No. S-63/TS (ECB)/90 on September 4, 1990.

TABLE 12.9

Valuation of Gold in Different Countries

Country	*Dollar/troy ounce*	*Valuation in Percentage of International Price*
USA	42.24	10.9
Japan	45.93	11.8
FRG	85.60	22.1
UK	291.00	75.0
France	415.17	107.0
Thailand	401.05	103.4
Pakistan	365.83	94.3
Malaysia	46.15	11.9
Brazil	400.67	103.3
Argentina	324.95	83.8
Peru	313.63	80.8
Kenya	170.00	43.8
Ghana	355.20	91.5
India	15.24	3.9

Notes: 1. International price taken at US$ 388 per troy ounce based on the LME price of September 3, 1990.

2. 1 troy ounce = 31.1035 gms.

Source: International Monetary Fund, computed from *International Financial Statistics, July 1990.*

The proposed amendment was as follows: In section 33, in sub-section (4), for the words and figures "gold coin and gold bullion shall be valued at 0.118489 gms. of fine gold per rupee", the following words were substituted, *viz.*, "gold coin and gold bullion shall be valued at a price not exceeding the international market price for the time being obtaining."

The amendment placed the prevailing international price as the ceiling for the rate of valuation; such revaluation was to be based on a standard norm with no scope for arbitrary valuation. Given that the international prices of gold were volatile, it was advisable to revalue gold assets periodically to present a more realistic picture of the country's foreign exchange holdings. The proposed amendment made this possible. To prevent excessive recourse to this enabling provision, it was possible to prescribe, from time to time, the range within which such revaluation could be done. Cabinet approval was sought and obtained for the proposed amendment to section 33(4) of the RBI Act, 1934.

In view of the urgency and secrecy involved, the President promulgated the RBI (amendment) ordinance 1990 on October 15, 1990. With effect from October 17, 1990, the gold holdings of the Reserve Bank were revalued nearer to the international market price.

UTILISATION OF GOLD TO RAISE FOREIGN EXCHANGE RESOURCES

To meet the unprecedented BoP crisis, the Reserve Bank in consultation with the Government evaluated a difficult option, *viz.*, utilisation of the gold held by the Bank and confiscated gold held by the Government to raise foreign exchange resources. Even the option of selling the gold was considered. However, since it was felt that the arrangement should be temporary as well as reversible, the sale with repurchase option was considered superior and was seen as being acceptable to the Indian public. Given the constraints of administering the scheme quickly, avoiding publicity and ensuring buy-back of the gold, it was felt necessary to deal with reputable bullion dealers and not through the large number of NRIs across the different countries. On January 16, 1991, the SBI sent a proposal to the Reserve Bank and the Finance Ministry to lease the gold at an acceptable cost. The Reserve Bank examined the SBI proposal in detail. On March 13, 1991 the Governor advised the SBI to accept the proposal and it was approved by the Government within a fortnight.

Twenty metric tonnes (MT) of gold from the government account was made available to the SBI for sale with a repurchase option to yield a little more than US$ 200.0 million. The financial terms and conditions and the procedure for sale and repurchase were finalised, based on the advice of the Reserve Bank on financial prudence and the need for secrecy and urgency. Accordingly, the UBS bought the gold from the SBI at the London fixing price prevailing on the day after the day of delivery for each consignment. The SBI was paid 95.0 per cent of the value of the gold as loan; the remaining 5.0 per cent of the payment was to be settled at the end of six months. The exact quantity of gold transacted by the SBI was 19.65 MT of assorted purity, corresponding to 18.36 MT of gold of 100.0 per cent purity. The consideration paid by the UBS to the SBI was US$ 200.0 million. The effective rate of interest was 6.33 per cent, corresponding to the LIBOR. The gold, in effect, was acting as collateral for the loan given by the UBS to the SBI. It was further agreed that if the price of gold changed beyond the original price by more than 5.0 per cent, a fresh transaction would take place. If the price went up by more than 5.0 per cent, the UBS

was to make available an additional loan to the SBI so that the total loan was 95.0 per cent of the new value. The gold was repurchased by the SBI in November/December 1991 and the gold of 18.36 tonnes was subsequently sold by the Government to the Reserve Bank. The remaining 1.63 tonnes of gold was returned by the SBI to the Government. Both these transactions added to the Reserve Bank's gold holding to the extent of 65.27 tonnes, which was kept abroad at that time.

Earlier, the SBI used to import gold to meet the needs of jewellery exporters under the gold jewellery export promotion and replenishment scheme. In order to conserve foreign exchange, the Government decided to stop importing gold with effect from October 1, 1990, and asked the SBI to use confiscated gold lying in the government mint for use by jewellery exporters.

The gold holdings of the Reserve Bank at US$ 3,499.0 million at end-March 1992 reflected an addition to gold stocks to the extent of 18.36 tonnes and reached a level of 350.92 tonnes. This addition resulted from the sale of gold by the Government to the Reserve Bank, equivalent to the value of US$ 191.0 million. As part of the reserves management policy and as a means of raising resources, the Reserve Bank in July 1991 pledged 46.91 tonnes of gold with the Bank of Japan (BoJ) and the Bank of England (BoE) and raised a loan of US$ 405.0 million. This loan was redeemed by the Reserve Bank by repayment between September and November 1991.

The Reserve Bank decided to approach the BoJ and the BoE for foreign currency loans against the pledge of gold, presumably because banks in Tokyo and London had not stopped accepting commercial bills. Also, the two central banks and commercial banks in these countries were favourably inclined to extend assistance to India. The Reserve Bank Governor paid a visit to the BoJ to hold discussions with his counterpart and deputed the chief of the Department of External Investments and Operation (DEIO), Reserve Bank to the BoE. Both the foreign central banking authorities were willing to extend loans only against securities like gold and that too against physical transfer of gold. They would not agree to the proposal that since the Reserve Bank was an IMF depository, it could keep the gold with itself. Accordingly, the Reserve Bank, under the personal supervision of the DEIO chief, arranged with utmost urgency and secrecy to airlift the gold to the BoE.[8]

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8. Transcript of the interview with Shri P.B.Kulkarni, former Executive Director, Reserve Bank of India.

In this connection, the Finance Minister made a statement in Parliament on July 18, 1991 articulating the entire issue of gold transactions by the SBI and the Reserve Bank and other measures envisaged to face the BoP challenge.

LIBERALISATION IN THE POLICY FOR IMPORT OF GOLD

The import of gold was considered to be non-productive and it was not considered prudent to use scarce foreign exchange resources for this purpose. Therefore, import of gold was highly restricted and was permitted only against a licence. The import of jewellery in passenger baggage was also restricted through the high rate of baggage duty and quantitative and value restrictions. There was, however, continuous and substantial import of gold over the years using illegal channels as indicated by the figures of seizures (Table 12.10).

TABLE 12.10

Seizure of Gold

(In tonne)

Year	*Seizure in India*	*Estimated Gold Smuggled into India*
1987	2.3	–
1988	6.1	–
1989	8.2	–
1990	5.7	170
1991	5.0	157
1992	2.9	166

Note: '–': not available.

Source: Reserve Bank of India, internal records, DEIO.

This led the Government to re-examine the issue of gold imports. In the budget of 1992–93, the Government partially liberalised the import of gold by introducing a window for passengers to import gold by paying duty in foreign exchange. Subsequent to the import trade control (ITC) order, which was issued by the Directorate General of Foreign Trade (DGFT),[9] Ministry of Commerce, the rate of duty was reduced from ₹ 450 per 10 gms. to ₹ 220 per 10 gms and passengers were given the option not to carry the gold themselves, but to purchase gold from SBI's bonded warehouse.

9. Order No. 83/90-93 dated February 29, 1992.

A similar scheme for the import of silver in baggage was announced with effect from February 9, 1993. Under this scheme, eligible passengers were allowed to import silver by paying duty in foreign exchange at the rate of ₹ 500 per kg up to a limit of 100 kg.

INDIA DEVELOPMENT BONDS

To attract foreign exchange from NRIs, two additional schemes were introduced in the second half of 1991–92. On October 1, 1991, the SBI launched IDBs for NRIs and overseas corporate bodies (OCBs). The bonds had a five-year maturity period and were denominated in US dollars and pound sterling. The dollar bonds carried an interest rate of 9.5 per cent and the sterling bonds 13.25 per cent. These bonds were freely transferable among NRIs/OCBs as also among Indian residents who received them as gifts from the former. The bonds were also free from income, gift and wealth taxes in India. The offer, which was initially opened up to November 30, 1991, was extended to January 31, 1992. An amount of US$ 1,085.0 million and GBP 165 million was collected under the schemes by February 1992.

The second scheme to mobilise additional foreign exchange was the remittance in foreign exchange (immunities) scheme of 1991. Under this scheme, the source of funds, purpose and nature of remittance were not subject to scrutiny under the exchange control regulations and direct tax laws. The Reserve Bank framed the scheme and advised all authorised dealers (ADs) in the country about the Remittance of Foreign Exchange and investment in Foreign Exchange Bonds (Immunities and Exemptions) Act, 1991, and section 3 (1) of this Act, which contained certain immunity clauses.

Under the above scheme, ADs were instructed to ensure that the remittances received were in convertible foreign exchange before issuing an immunity certificate to the declaring beneficiary. However, the Reserve Bank suspected that the scheme was being misused, when it noticed a sudden spurt in drawals from the accounts of the Reserve Bank for foreign economic affairs of the erstwhile USSR during December 1991. The Reserve Bank, therefore, conducted snap inspections of some ADs, which revealed that at some branches non-convertible rupee funds were erroneously used to claim immunity under the scheme, although only remittances received in free foreign exchange were eligible. In February 1992, the Reserve Bank advised ADs to carry out investigations at their

branches and furnish details of the cases where immunity was wrongly claimed. Based on the Reserve Bank circular, some ADs cancelled the immunity certificates that had been issued by mistake. These cases were also referred to the Enforcement Directorate and the Ministry of Finance. The Reserve Bank in a communication[10] to the Finance Secretary suggested taking penal action against the parties who had tried to misuse the scheme to evade tax. The issue was whether criminal liability could be fixed on the recipients of the remittance for claiming immunity under the scheme, where the remittance was by debit to an NRE account in India but the rupees were non-convertible rupees or where no remittance in convertible foreign exchange was received.[11] Under the above scheme, an amount of US$ 766.0 million was received till February 10, 1992 to support the declining foreign exchange reserves.

NON-RESIDENT DEPOSITS

The gulf crisis had exerted enormous pressure on remittances from the gulf region. A special FCNR deposit scheme was introduced from August 21, 1990 to attract deposits from the gulf region. Deposits under the scheme were designated only in US dollars. These deposits were open-ended and, therefore, did not have a definite term. The scheme allowed withdrawal of full or part of the sum deposited without notice. There were no restrictions on the number of withdrawals from the account. It had a provision of exchange protection for NRIs as well as OCBs residing in the gulf region. While no interest was payable on balances under the scheme, the exemptions with regard to wealth tax and gift tax as applicable to balances under the existing FCNR scheme were applicable to balances held under this scheme. The interest rates on non-resident deposit schemes continued to be above the rates applicable to domestic deposits of comparable maturities. Some rationalisation of interest rate was effected in consonance with those of domestic deposits (Table 12.11).

10. D.O. letter No. EC CO INSP 38/11R-92/93 dated July 3, 1992.

11. This was vetted by the Reserve Bank's Legal Department on the advice of the Ministry of Finance. The opinion of the department was communicated to the ministry through a D.O. letter signed by the Deputy Governor on November 3, 1992.

TABLE 12.11

Rate of Interest on Term Deposits under NR(E)RA and FCNR(A)

(Per cent per annum)

Maturity	*NR(E)RA*	*FCNR(A)*			
		Pound Sterling	*US Dollar*	*DM*	*Yen*
1 year and above but less than 2 years	10.50	12.00	5.75	10.25	7.00
2 years and above but less than 3 years	11.00	12.00	6.75	10.50	7.00
3 years and above but less than 5 years	13.00	12.00*	7.50*	10.50*	7.00*
5 years and above	14.00	–	–	–	–

Notes: *3 years only.
'–': not applicable.

Source: Government of India, *Economic Survey, 1991–92.*

FCNR SWAP SCHEME

Deposits under the FCNR scheme could be accepted in four currencies, *viz.*, pound sterling, US dollar, DM and Japanese yen. To facilitate interchangeability of the designated currencies, it was decided that if a customer with any other convertible currency wanted to place a deposit under the scheme, there would be no objection to ADs undertaking a fully covered swap in that currency against one of the four designated FCNR currencies with an NRI depositor. This enabled a depositor with a non-FCNR currency to participate in the FCNR scheme.

NEW NON-RESIDENT (NON-REPATRIABLE) RUPEE DEPOSIT SCHEME

With a view to providing further incentives to non-residents and OCBs owned by them, the captioned scheme was announced. Under this scheme, ADs were permitted to accept deposits through transfer of foreign exchange from abroad or from an existing NRE/FCNR account. The transferred funds were converted into rupees at the prevailing exchange rate and such funds were not repatriable. The new deposit scheme had a maturity period of six months to three years, and the deposits therein were not considered a part of demand and time liabilities for the purpose of reserve requirements. Further, lending out of these deposits was not considered as part of net bank credit for the purpose of priority sector lending. The deposits and advances out of them were not subject to interest rate regulations. With these attractive features, ADs were able to attract foreign exchange on a non-repatriable basis.

LIBERALISATION OF IMPORT LICENSING

The import licensing system developed over the years was characterised by bureaucratic delays and arbitrariness and was vulnerable to charges of corruption and misuse. The system operated to the disadvantage of smaller enterprises, which typically found it difficult and more expensive to obtain licences. A step towards simplifying the system was taken in July 1991 with the introduction of Exim scrips. These were tradeable import licences issued to exporters for 30.0 per cent of the value of exports. Exim scrips could be used to import a wide range of items, which had earlier been imported against supplementary licences that stood abolished with the introduction of Exim scrips. Exim scrips traded at a premium, which accrued to exporters. The trade regime was further liberalised with a higher rate of 40.0 per cent Exim scrip entitlement for high value-added and other products. These were significant steps in moving away from a regime of quantitative restrictions. The new industrial policy set out a series of important policy initiatives in relation to industrial licensing, foreign direct investment (FDI), foreign technology agreements, public sector policy and the Monopolies and Restrictive Trade Practices (MRTP) Act. The basic thrust of the policy was to free industries from controls, which inhibited decision-making on business principles, and let entrepreneurs make investment decisions based on their commercial judgement.

In view of the depleting BoP position, the credit policy for the first half of the year announced on April 12, 1991 took certain steps directly aimed at import containment. Cash margins ranging between 50.0 and 200.0 per cent were prescribed for imports in certain categories. Significantly, imports related to exports were given a concessional treatment and there was an exemption from cash margins in general against such imports. The cost of import finance was increased sharply, which was expected to accelerate export realisation. Even while imposing tight monetary controls, care was taken to ensure that export efforts were not adversely affected. For this reason, in the case of imposition of cash margins, imports meant for exports were generally excluded from the restrictions.

INCENTIVES FOR EXPORTS

It was realised that excessive resort to import compression measures to narrow the widening trade deficit had proved to be counterproductive. Hence, there was a paramount need to promote exports. To provide greater incentive to banks to render export credit, the export credit refinance formula was liberalised. The access of banks to funds under

this facility was increased. With effect from September 4, 1991, the refinance limit under the first tier was raised to 60.0 per cent as against 50.0 per cent earlier, while continuing export credit refinance at 100.0 per cent under the second tier. To provide additional incentive to banks, refinance under the second tier was raised to 110.0 per cent effective November 2, 1991 and further to 125.0 per cent from December 28, 1991. In view of the low interest rate on export credit, banks were not finding it remunerative to lend to the export sector. With large interest rate differentials between export credit and other credit, there was a strong possibility of seepage of credit. To provide greater incentive to banks and to enable them to provide credit support for export promotion, interest rates on pre-shipment and post-shipment export credit were raised in August 1991 and again in October 1991. Further, a series of relaxations were also offered in the prescribed cash margins for imports related to exports. A new refinance facility, refinance scheme for post-shipment export credit denominated in US dollars was introduced on January 4, 1992. Under this scheme, refinance was provided to banks equivalent to 133.33 per cent of post-shipment export credit denominated in US dollars. The rate of interest on refinance under the scheme was also reduced on three occasions during 1992. The Reserve Bank delegated powers to ADs to allow extension of the period for pre-shipment credit by 90 days in cases where exporters could not effect the shipment of goods within a period of 180 days for reasons beyond their control.

Export incentives to exporters and interest incentives and refinance facilities to banks were revised from time to time to boost India's exports. Such measures yielded desired results as indicated in Table 12.12.

TABLE 12.12

India's Export Trade

(US$ million)

Year	*Exports*		
	Oil	*Non-oil*	*Total*
1991–92	414.7	17,450.7	17,865.4
1992–93	476.2	18,061.0	18,537.2
1993–94	397.8	21,840.5	22,238.3
1994–95	416.9	25,913.6	26,330.5

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2009–10.*

LIBERALISATION OF TARIFFS

The customs tariff reforms were focused on reducing protection by rationalising the average tariff rate and minimising arbitrary distribution of protection among industries by decreasing tariff dispersion. An array of exemptions had been built up over the years in the tariff structure in response to demands from various stakeholders, which were not in the interests of the economy. The Chelliah Committee report on tax reforms addressed these anomalies and helped remove these distortions.

With the peak customs tariff rate at around 300.0 per cent in 1990–91, the 1991–92 budget cut the peak rate to half (150.0%), followed by another cut in the peak rate to 110.0 per cent in the 1992–93 budget. In view of the significance of capital goods imports, a reduction in import duty on capital goods was effected by reducing the general rate to 55.0 per cent in 1992–93. For some categories of capital goods, the duty was set even lower (*e.g.*, 50.0% for the electronic industry). As a result, the customs duty collection rate fell from 47.0 per cent in 1990–91 to 44.0 per cent in 1991–92 and further to 37.0 per cent in 1992–93.[12]

INDUSTRIAL DEREGULATION

Industrial deregulation envisaged to abolish industrial licensing requirements except for a short list of industries. It abolished the concept of monopoly by introducing limits on the assets of large industrial houses. The policy also reduced the number of industries reserved exclusively for the public sector and ensured competition between the public and private sectors, besides prescribing measures to enhance incentives to promote small, tiny and village industries.

FOREIGN INVESTMENT POLICY

Until 1990, foreign investments were limited. During the period 1986–1990, direct foreign investment approvals stood at ₹ 900 crore, resulting from the relatively restrictive foreign investment regime. Foreign investments were allowed in areas of hi-tech/sophisticated technology and substantial exports. The normal ceiling for investment was 40.0 per cent of the total equity capital, but a higher percentage of foreign equity was considered in priority industries, if the technology was sophisticated and not available within the country.

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

In July 1991, the Government announced a liberalised investment policy as part of a new industrial policy. The shift in the policy had important implications for the Reserve Bank as the manager of foreign exchange and its stocks. The new regime of foreign investment contained the following:

(i) Automatic approval of direct foreign investment up to 51.0 per cent of foreign equity holding in 34 specified high-priority capital-intensive high-technology industries; provided the foreign equity covered the foreign exchange involved in importing capital goods and outflows on account of dividend payments were balanced by export earnings over a period of seven years from the commencement of production.

(ii) Foreign technology agreements were also liberalised for 34 industries, with firms left free to negotiate terms of technology transfer based on their own commercial judgement and without prior government approval for hiring foreign technicians.

(iii) To avail of professional marketing and exploration of world markets for foreign products, foreign equity holding up to 51.0 per cent was permitted for trading companies.

(iv) The Foreign Investment Promotion Board (FIPB) was set up to look into where higher foreign equity limits of more than 51.0 per cent could be permitted.

The results of the new foreign investment policy were encouraging. Approvals of overseas investment reached a peak of US$ 230.1 million during 1991, including approvals given by the Reserve Bank till December 1991 as against US$ 73.1 million during 1990. Several additional measures were introduced during 1992–93 to encourage investment flows: FDI, portfolio investment, NRI investment and deposits, and investment in global depository receipts (GDRs). These measures were:

(i) Existing companies were allowed to raise the foreign equity to 51.0 per cent subject to certain prescribed guidelines. FDI was allowed for exploration, production and refining of oil and marketing of gas.

(ii) NRIs and OCBs predominantly owned by NRIs were permitted to invest 100.0 per cent equity in high-priority industries with repatriability of capital and income. NRI investment up to 100.0 per cent equity was permitted in export houses, hospitals, export-

oriented units (EOUs), sick industries, hotels, and tourism-related industries.

(iii) Disinvestment by foreign investors no longer needed to be at a price determined by the Reserve Bank. It was allowed at the market rate on the stock exchange from September 15, 1992.

(iv) On April 13, 1992, India signed the multilateral investment guarantee agency protocol for the protection of foreign investments.

(v) Foreign companies were allowed to use their trademarks on domestic sales.

Between August 1991 and December 1992, the Government approved 2,154 foreign collaboration proposals, including 894 cases with foreign equity participation. The details of foreign investment inflows are given in Table 12.13.

TABLE 12.13

Foreign Investment Inflows

Year	*A. Direct Investment*		*B. Portfolio Investment*		*Total (A+ B)*	
	₹ crore	*US$ million*	*₹ crore*	*US$ million*	*₹ crore*	*US$ million*
1990–91	174	97	11	6	185	103
1991–92	316	129	10	4	326	133
1992–93	965	315	748	244	1713	559
1993–94	1,838	586	11,188	3,567	13,026	4,153
1994–95	4,126	1,314	12,007	3,824	16,133	5,138

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2008–09.*

The Government allowed reputed foreign institutional investors (FIIs) including pension funds, mutual funds and asset management companies (AMCs) to invest in the Indian capital market on the condition that they registered with the Securities Exchange Board of India (SEBI) and obtained approval under Foreign Exchange Regulation Act (FERA) from the Reserve Bank. Portfolio investment by FIIs in the primary and secondary markets were subject to an overall ceiling of 24.0 per cent of issued share capital of a company and subject to the investment between equities and debentures in the ratio of 70:30.

EXCHANGE RATE POLICY

The policy developments with regard to the exchange rate of the rupee were influenced by considerations such as immediate countering of market expectations and those of longer-term reforms. The rupee was linked to a basket of currencies of the country's major trading partners during September 01, 1975 to February 28, 1992. The GBP was the intervention currency until March 03, 1993, which was replaced by the US dollar on March 04, 1993. From the early 1980s, the exchange rate had been used as a policy instrument to achieve a sustainable CAD by ensuring improvement in the price competitiveness of exports. The rupee value underwent several adjustments over the years from 1985 onwards. The adjustment made in July 1991 was accompanied by the new trade policy. The Reserve Bank effected an exchange rate adjustment on July 1, 1991. There was another downward adjustment of the exchange rate on July 3, 1991. Overall, the two-step downward adjustment of the rupee worked out to 17.38 per cent in terms of the pound sterling and 18.7 per cent in US dollar terms. The adjustment was necessitated by the growing external and internal imbalances in the economy.

Since October 1990, there had been an appreciation in the real exchange rate of the rupee as a result of the relatively high rate of inflation in the country and much slower rate of depreciation in the nominal exchange rate, leading to erosion in the international competitiveness of the economy. It was equally necessary to curb destabilising market expectations. In determining the extent of adjustments, four factors were kept in mind: (i) inflation differentials between India and major industrial countries; (ii) the extent of real depreciation of the currencies of the countries competing with India; (iii) the degree of correction required in BoP; and (iv) broad indicators of market expectations. Taking all these factors into account, the depreciation in the rupee value against US dollar by 18.0–19.0 per cent seemed appropriate. The objective of this sizeable downward adjustment was to dampen market anticipation so as to offer incentives for remittances and capital inflows and also to treat it as a part of the stabilisation and structural reform programme.

The new trade policy of July 1991 introduced a system of Exim scrips under which exporters earned freely tradeable import entitlements equivalent to 30.0 per cent (or 40.0% in some cases) of the value of their exports. The system of Exim scrip, however, faced many operational and other problems. First, it was limited in scope, with invisibles receipts including private remittances left out of the incentive scheme. Any

extension of it to a large number of transactions could be cumbersome and difficult to operate. Second, Exim scrip assumed the character of yet another licence, which needed to be avoided, particularly because of the administrative work load required to issue and verify the licences. The high level committee on balance of payments (BoP) (Chairman: Dr C. Rangarajan) appointed by the Government in November 1991 was of the view that while retaining the essential elements of linking imports with exports and offering incentives to exporters, any new system should avoid the need for issue of licences, should cover service and remittance transfers, and should preferably operate through the banking system. On its recommendations, the concept of LERMS was developed after extensive discussions and conceptual inputs both from the Reserve Bank and the Ministry of Finance.

Initially, the concept of a full-fledged market determined dual exchange rate was considered, which had self-equilibrating properties and could automatically ensure BoP balancing. This system was, however, administratively tied to what was called a foreign exchange certificate and was considered to be a more comprehensive version of Exim scrip. A detailed concept paper on liberalising the foreign exchange market using a dual exchange rate was prepared in November 1991 by the Ministry of Finance. This was titled: Towards Rupee Convertibility: The Convertible Rupee Account. The paper was sent to the Governor, Reserve Bank on December 26, 1991, members of the Planning Commission and the Commerce Secretary for their comments.

The paper was vetted by the Reserve Bank and a detailed note prepared by the Department of Economic Analysis and Policy (DEAP), which brought out the deficiencies in the paper. The Ministry revised the paper in light of the Reserve Bank's comments and renamed it as: Towards Rupee Convertibility: A Free Market Exchange Rate Channel. The new document was forwarded by the Ministry on January 21, 1992 to the Reserve Bank with a request to ensure that all relevant points were captured in the paper. In the meantime, in mid-February, the Reserve Bank prepared a paper titled: Liberalised Exchange Rate Arrangements (LERA), based on a joint note compiled by the Exchange Control Department (ECD), the DEAP and the DEIO. The Reserve Bank paper noted:

> In the trade policy announcement of July 4, 1991, the Minister of State for Commerce, Government of India said he hoped that rupee would become fully convertible on trade account in three to five years. Since then there had been interaction between Government

> and the Reserve Bank on the scope of convertibility and many ideas had been thrown up. In his interview to the Economic Times (January 6, 1992), the Finance Minister indicated his preference for convertibility on both current and capital accounts. The discussion so far had helped in convergence of certain ideas, which enabled us to focus on the action to be taken in the coming months. In fact the efforts of the Reserve Bank helped to prepare the blueprint of the future LERMS.

The paper spelt out in detail how the market channel of the exchange rate could be operated through the banking system, conforming to the recommendations of the Rangarajan Committee.

Discussions took place between officials of the ministry and the Reserve Bank on the operational issues covered in the concept paper. LERA was renamed as LERMS, as announced in the budget of 1992–93. LERMS was not to be viewed as a measure in isolation; it formed a part of the liberalisation measures undertaken by the Government and the Reserve Bank, including permission to NRIs to import gold. Apart from providing a boost to exports, it aimed at efficient import substitution with as little bureaucratic and discretionary controls as possible. It sought to encourage remittances through banking channels and reduced incentives for clandestine transactions. LERMS was a system in transition. It subsumed the declared objective of movement to full convertibility on the current account in future. The Rangarajan Committee had emphasised that to achieve the full benefit of integrating the Indian economy with the world economic system, the country had to move step by step towards full convertibility of current account transactions, keeping in view the developments in the macroeconomic situation and the world trading environment. It also envisaged that the proportion of official allocation of foreign exchange for the purposes of public good and other items could be gradually reduced, thus increasing the proportion of foreign exchange that the importers could buy from the market.

FOREIGN CURRENCY ACCOUNTS

All exporters of goods and services and other recipients of inward remittances in convertible currencies were allowed to retain up to 15.0 per cent of the receipts in foreign currency accounts with banks in India out of the amount to be surrendered at free market rates. They could utilise these funds to meet current account payments permitted under the trade and

exchange control regulations. In view of this, the existing blanket permit, CAFEX[13] permit and BAFEX[14] permit schemes were discontinued.

The existing broad-based facility for maintaining foreign currency accounts, either in India or abroad, for crediting proceeds of all exports to countries in the external group for making payments from such accounts for financing imports and repayment of foreign currency loans, continued at that point. Exporters holding such foreign currency accounts were, however, required to surrender 40.0 per cent of their export proceeds to ADs at official rates as per the provisions of LERMS with effect from March 1, 1992. No rupee loans were permitted to be sanctioned against balances in foreign currency accounts.

MARKET INTERVENTION

The Reserve Bank also undertook, at its discretion, foreign exchange operations at market rates. In pursuance of the notifications containing the details of LERMS issued by the Government under section 40 of the RBI Act, 1934, the Bank issued operational instructions to ADs through circulars. In addition to the salient features of the scheme, the Reserve Bank announced that the official exchange rate would be expressed in US dollars per ₹ 100. ADs were instructed to immediately report by fax or telex to the Controller, ECD, all their overbought and oversold foreign currency positions as well as their *nostro* account balances as at close of business on February 29, 1992. ADs were warned that if any of them maintained an overbought position in any foreign currency on the date cited above or built-up balance in *nostro* accounts in violation of the provisions of the exchange control manual, the Reserve Bank could take action for violation of the provisions. In the case of a forward purchase contract permissible under current account receipts, ADs were instructed to purchase forward from customers 40.0 per cent of foreign exchange receipts at rates based on the forward buying rate of the Reserve Bank. These purchases could be covered with the Reserve Bank. The balance 60.0 per cent could be purchased forward at the free market rate.

ADs were instructed to communicate to the dealing room of the DEIO at the Reserve Bank on every business day between 4.00 pm and 6.00 pm — the range (high and low) of their US dollar telegraphic transfer (TT) sales and TT purchase rates during the day in the free market. The

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13. Composite allocation of foreign exchange.

14. Block allocation of foreign exchange.

minimum amount and the multiples in which purchase of GBP, US dollar, DM and Japanese yen could be made by the Reserve Bank were revised. The minimum amount of spot sales of the US dollar by the Reserve Bank was also fixed. The minimum amounts and multiples in which purchases by the Reserve Bank were revised are given in Table 12.14.

TABLE 12.14

Sale/Purchase of Currencies

Currency	*Existing*		*Revised*	
	Minimum	*Multiples*	*Minimum*	*Multiples*
GBP	10,000	1,000	1,00,000	10,000
US dollar	25,000	5,000	2,50,000	25,000
DM	40,000	5,000	4,00,000	40,000
Japanese yen	5,000,000	1,000,000	30,000,000	3,000,000

Source: Government of India, Notification on LERMS, March 1, 1992.

Restricted money-changers were instructed to sell daily their purchases of foreign currency notes and travellers' cheques (except to the extent of foreign currency cash floats permitted to be kept by them) to ADs, who would purchase 40.0 per cent of the amount at rates based on the official rate for surrender to the Reserve Bank and the balance 60.0 per cent at rates based on free market rates. Full-fledged money-changers had to sell daily to ADs at least 40.0 per cent of their gross collections at the official rate. Consequent to the new exchange rate arrangement, money-changers had to buy foreign currency travellers' cheques and currency notes and sell foreign currency notes from/to members of the public at suitable rates. ADs were instructed to bring these instructions to the notice of their money-changer constituents.

As observed by a government official, "The announcement of this system in the budget took the entire country as well as foreign observers and well wishers completely by a surprise. The extent of excitement among common people, those who may never have the opportunity to undertake foreign exchange transactions, took even those involved in its preparation by surprise. Even the common person welcomed the freedom that it implied and the confidence that it denoted on the part of the Government. Many economists predicted that there would be huge capital outflows and the rupee would sink to ₹ 40 per US$ on the market channel. Some even predicted a free fall to ₹ 50 per US$. The market exchange rate opened

around ₹ 31.27 per US$ in March 1992 and rose to ₹ 30.87 per US$ in January 1993."[15]

INDO-USSR TRADE PROTOCOL

For the calendar year 1991, the Indo-USSR trade protocol (prior to the break-up of the USSR) envisaged a total trade turnover of ₹ 9,411 crore comprising ₹ 5,081 crore of exports to the USSR and ₹ 4,330 crore imports from the USSR. Against this target, a total trade turnover of ₹ 6,413 crore was actually realised during 1991. Consequent upon their separation, the countries of the erstwhile USSR formed the Commonwealth of Independent States (CIS), and efforts were made by the Government of India and the republics of the CIS to establish trade and economic links with each other. Such agreements were reached between India and six republics, *viz.*, Kazakhstan, Kyrgyzstan, Russian Federation, Turkmenistan, Ukraine and Uzbekistan. All the republics opted for payments in freely convertible currencies. The general form of agreement between India and the republics of the CIS was that they would accord to each other the most favoured nation (MFN) treatment in all matters of trade and commercial co-operation.

RUPEE DEBT OWED TO RUSSIA

After the collapse of the USSR, a new agreement was reached between India and Russia in January 1993 for the repayment of loans and credits extended by the USSR to India. The rupee debt converted from the roubles stood at around ₹ 31,000 crore, comprising principal debt of ₹ 19,000 crore and rescheduled debt of ₹ 12,000 crore.

As per the agreement, the outstanding debt in Russian roubles as on April 1, 1992 was converted into Indian rupees based on the rate of exchange prevailing on January 1, 1992 (one rouble equalled ₹ 19.9169) and termed as principal debt. The principal debt was to be repaid as per the original repayment schedule enshrined in the loan agreements. In terms of the protocol, the principal debt attracted an interest rate of 2.5 per cent.

However, the outstanding debt in roubles was also converted into Indian rupees at the exchange rate as on April 1, 1992, *i.e.*, one rouble equal to ₹ 31.7514 in terms of the new agreement. The difference between the principal debt and the amount based on April 1, 1992 rupee-rouble exchange rate was called rescheduled debt, which was to be repaid in 45

15. Virmani (2001) *op. cit.*

years. The rescheduled debt attracted no interest. The last instalment of rescheduled debt would fall due in 2037, while that of principal debt was paid in 2007.

According to the agreement, both parts of the debt, *viz.*, the principal and the rescheduled were to be revalued as and when the rupee appreciated or depreciated against SDR by more than 3.0 per cent and accordingly the revaluation was done from time to time.

Apart from the rupee debt, a foreign currency loan was contracted on September 17, 1992, for an amount of ₹ 1,091.23 crore with a repayment period of around 14 years to supply defence equipment to India.

BoP MONITORING GROUP

A BoP monitoring group was constituted by the Government[16] and the Deputy Governor of the Reserve Bank was a special invitee. The high-powered group closely monitored the developments on issues related to monetary, fiscal, industry and trade (both domestic and foreign) with particular emphasis, *inter alia*, on export promotion, import liberalisation and industrial deregulation against the background of the prevailing BoP situation. The BoP monitoring group in its meeting on May 6, 1991 considered a note from the commerce ministry entitled Impact on Exports of RBI Restrictions and concluded that the commerce ministry and the finance ministry should hold further discussions with the Reserve Bank on the proposed relaxations. It was recognised that some steps were needed to protect export performance, but the meeting remained inconclusive. Subsequently, on May 16, 1991, the commerce ministry forwarded certain proposals termed as minimal package of modifications to the existing import compression measures in respect of export-related imports to the Reserve Bank. Some of the important proposals were as under:

(i) The Reserve Bank should issue clear instructions that LCs for all export-related imports such as advance licences, special imprest licences and replenishment (REP) licences should have absolute priority not only for RBI clearances but also clearance by regional offices and head offices of commercial banks.

(ii) In the case of all export-related imports, the existing limits should be relaxed.

16. The group was chaired by Secretary (Economic Affairs), Ministry of Finance, Government of India.

(iii) The cumulative limit for individual importers, beyond which all LCs would need centralised clearances by the Reserve Bank, could also be liberalised.

(iv) Many exporters required access to imported materials, which were not imported against advance licences but against OGL or supplementary licences. These imports continued to attract margins. Such exporters should be allowed certain margin-free entitlement of imports.

These proposals were part of the full package of liberalisation in favour of exports, which were proposed in the commerce ministry's note forwarded earlier to the Reserve Bank through the BoP monitoring group. The Reserve Bank promptly announced a number of relaxations through a press note released on June 4, 1991.[17] After consultations with the Reserve Bank, the Government announced the new trade policy in July 1991, which introduced the system of Exim scrip as a major export-related import measure for the benefit of exporters.

COMMITTEE ON BALANCE OF PAYMENTS: SETTING THE WAY FORWARD

The high level committee on BoP[18] constituted by the Government under the chairmanship of Dr C. Rangarajan submitted its interim report in February 1992 and its final report in April 1993. The committee made wide-ranging recommendations on various aspects of India's BoP and a number of its recommendations formed inputs for the policy decisions during that period.

Favouring a realistic exchange rate, the committee recommended the unification of exchange rates as an important step towards full convertibility. In pursuance, the unified exchange rate system was introduced with effect from March 1, 1993. The committee also recommended that a reserve target range should be fixed from time to time, taking into account the need to accommodate three months of imports and other payment obligations. In the committee's view, the reserves should not be allowed to fall below the floor level. Further, the option of the Reserve Bank converting gold into foreign currency resources should be constantly reviewed, although the immediate case for exercising such an option was not established. In

17. For details, refer to Appendix 12.1.
18. Reserve Bank of India, *Annual Report, 1992–93.*

addition, the committee recommended that a part of the gold reserves should be available for conversion at a short notice into currency resources to meet any contingencies.

With regard to external assistance, the committee recommended that 100.0 per cent of external assistance should be passed on to the states for all sectors. It considered that commercial borrowings with a maturity period of less than five years should not be encouraged, and favoured a cautious approach to sovereign guarantees on external borrowings. It suggested an annual limit of US$ 2.5 billion in the case of disbursements of ECBs. Further, the committee concluded that debt-equity conversion was not a desirable option for debt management in India. The committee recommended launching the gold bonds as an experiment.

To reduce the volatility and cost of NRI borrowings, the committee advocated a minimum maturity period of one year in the case of FCNR deposits and a gradual reduction in the difference between international interest rates and FCNR rates. The committee also favoured the development of markets for NRI bonds to attract medium-term investment by NRIs.

The committee observed that short-term debt should be permitted only for trade-related purposes. The committee further proposed setting-up a monitoring system for short-term debt to ascertain the extent of outstanding short-term debt at any point of time. With a view to attracting foreign investment, the committee favoured a national investment law to codify the existing policy and practices relating to dividend repatriation, disinvestment and employment of foreign nationals.

For the medium term, the committee considered it necessary to achieve an annual growth in exports of at least 15.0 per cent in dollar terms. Further, it felt that a CAD of 1.6 per cent of GDP could be maintained through a sustained level of net capital receipts.

CONCLUDING OBSERVATIONS

The process of liberalisation of the Indian economy and the financial sector reforms had begun before the crisis of 1991. During the 1980s, the early reform measures and the process of liberalisation was undertaken in a limited way. These steps, though encompassing several sectors, lacked a coherent approach. The reforms helped the country lift its growth in the late 1980s, breaking away from the long-term rate of growth of around 3.5 per cent. However, an inconsistent framework of the process of reforms increased the vulnerabilities of the economic system and the efforts were

thwarted by pressures on public finances and the external sector. It was only when the country faced the threat of a default in its external payments that the 20-month IMF programme of stabilisation and structural adjustment was initiated during 1990–91 to 1992–93, which paved the way for wide-ranging reforms. The Government and the Reserve Bank were both involved in executing the measures needed to bring about macroeconomic stabilisation and structural adjustment from late 1989 and through 1990. Political uncertainty and change of governments delayed official action in approaching the multilateral institutions, despite the Reserve Bank signalling the need for the same to the Government since the late 1989.

Incipient signs of the BoP crisis were evident in the second half of 1990–91 when the gulf war led to a sharp increase in oil prices. Foreign exchange reserves began to decline from September 1990 due to a sharp rise in the imports of oil and petroleum products. The effect of the rise in oil prices was aggravated by the events that followed. Indian workers employed in Kuwait had to be airlifted back to India and their remittances ceased to flow in. Other adverse developments, reflecting the loss of confidence in the Government's ability to manage the situation, exacerbated the crisis further. Short-term credit began to dry up, imposing a severe strain on the BoP position. In addition, the outflow from NRI deposits was substantial. The import cover of reserves declined to three weeks of import value by the end of December 1990.

The overvaluation of the Indian rupee in the latter half of the 1980s *vis-à-vis* its Asian counterparts, and subsequently from October 1990 to March 1991, witnessed an appreciation of the REER of the Indian rupee by about 2.0 per cent as a consequence of the widening inflation differentials between India and the major industrialised countries, thereby eroding the international competitiveness of India's exports. To stem the loss of competitiveness and on account of the dwindling foreign exchange reserves, India resorted to devaluation of the rupee. The Reserve Bank effected an exchange rate adjustment in two stages: on July 1, 1991 and another adjustment on July 3, 1991. The two-step downward adjustment of the Indian rupee in terms of pound sterling worked out to 17.38 per cent and in terms of the US dollar about 18.7 per cent.

As part of the crisis management measures undertaken during 1990–91 to 1992–93, the Reserve Bank in consultation with the Government changed the method of valuation of gold held as foreign exchange reserves. It was felt that revaluation of the gold holding from time to time in accordance with international price movement could present a more realistic picture

of India's foreign exchange reserves. To meet the unprecedented BoP crisis, and to avoid risking a default in its external payments, India chose to sell 20 MT of government gold with a re-purchase option to the UBS through the SBI, yielding a little more than US$ 200.0 million. Later, as a part of the reserves management policy and as a means of raising resources, the Reserve Bank in July 1991 pledged 47 tonnes of gold with the BoE and BoJ and raised a loan of US$ 405.0 million.

The Government that took office in June 1991 acted quickly to address the deteriorating economic situation. From July 1991, the authorities (both the Government and the Reserve Bank) addressed with utmost speed and determination the issues of stabilisation and structural reforms, fiscal correction, exchange rate adjustment and reform, monetary targets and inflation control for the overall macroeconomic stability. These measures were supported by structural reforms in the form of industrial deregulation, liberalisation of FDI, trade liberalisation and financial sector reforms.

The crisis management and its successful resolution paved the way for liberalisation and led to economic and financial sector reforms. The reforms process comprised the following: industrial licensing for all except 18 industries was abolished; investment caps on large industrial houses were removed; only 6 industries remained exclusively in the public sector; access to foreign technology was liberalised; import licensing was virtually abolished; import duties were sharply reduced; and exporters could open foreign currency accounts.

To attract foreign exchange resources from NRIs, two new schemes were introduced in the second half of 1991–92. On October 1, 1991, the SBI launched the IDBs for NRIs and OCBs. The second scheme for mobilising additional foreign exchange resources provided immunity to NRIs, exempting them from scrutiny of the source of funds, purpose and nature of remittance under the exchange control regulations and direct tax laws.

A high-powered committee (Chairman: Dr C. Rangarajan) made several recommendations that set the tone for policies in managing the external sector during the years of reform following the crisis. A BoP monitoring group was constituted by the Government to closely observe developments in monetary, fiscal, industry and trade (both domestic and foreign) with particular emphasis on export promotion, import liberalisation and industrial deregulation against the background of the prevailing BoP situation.

The policy with regard to the exchange rate of the rupee was to counter the destabilising market expectations and undertake longer-term reforms to ensure the development of a deep and vibrant exchange market. The new trade policy of July 1991 introduced a system of Exim scrips, which faced several operational problems. The high level committee on BoP was of the view that for linking imports with exports and motivating exporters, the new system should avoid the need for issuing licences and should preferably operate through the banking system. After extensive discussions on several concepts with the Ministry of Finance, the Reserve Bank prepared a paper titled LERA, which was renamed as LERMS subsequently. LERMS effectively brought in a dual exchange rate system. LERMS was a system in transition and it subsumed the declared objective of movement towards full convertibility on the current account later in 1994.