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# Macroeconomic Context

The decade of the 1980s began with uncertainties on several fronts. Domestically, there was a severe drought in 1979 and on the global front, the oil crises of 1973 and 1979 endangered economic stability. The immediate impact of these developments was rising inflationary pressures. The economic policy debate during the decade was thus dominated by concerns regarding rising prices. The Government and the Reserve Bank responded to these economic challenges through a variety of policy measures directed at relieving the basic causes of the economic difficulties and minimising their impact on vulnerable sections of society.

On the external sector front, the unfavourable foreign trade situation in the aftermath of the spike in oil prices became more pronounced. The foreign exchange reserves declined. Notwithstanding the decline in foreign exchange reserves, the pace of monetary expansion continued unabated. The external payments position remained difficult as a result of a persistent increase in imports combined with only a modest rise in the rate of growth in the value of exports. The widening trade deficit became one of the most pertinent concerns of the policymakers. The current account deficit (CAD) rose sharply to ₹ 2,748 crore (US$ 3,474.0 million) or 1.6 per cent of the gross domestic product (GDP) in 1980–81. In order to tide over the balance of payment (BoP) difficulties, the Government negotiated a loan of SDR 5 billion under the extended fund facility (EFF) of the International Monetary Fund (IMF) in November 1981.

While the average growth rate in real GDP was satisfactory, having upturned from 2.9 per cent per annum during the 1970s to 5.8 per cent during the 1980s, the fiscal aggregates worsened. Gross fiscal deficit (GFD) as a percentage of GDP (in average terms) rose from 3.8 per cent to 6.8

TABLE 2.1

*Key Macroeconomic Variables: Decadal Trends*

| *Variables* | | *1970–71 to 1979–80* | *1980–81 to 1989–90* |
|---|---|---|---|
| *I.* | *Real GDP Growth Rate (%, base 1993–94=100)* | 2.9 | 5.8 |
| | Agriculture | 0.6 | 4.4 |
| | Industry | 4.7 | 7.4 |
| | Services sector | 4.1 | 6.4 |
| *II.* | *Sectoral Shares* | | |
| | Agriculture as % of GDP | 42.8 | 36.4 |
| | Industry as % of GDP | 16.9 | 19.5 |
| | Services as % of GDP | 40.3 | 44.0 |
| *III.* | *Index of Industrial Production (IIP)* | 4.5 | 7.8 |
| *IV.* | *Fiscal Indicators* | | |
| | Centre's GFD (as % of GDP) | 3.8 | 6.8 |
| | State's GFD (as % of GDP) | 2.9 | 2.9 |
| | Combined GFD (as % of GDP) | – | 8.0 |
| *V.* | *Gross Domestic Savings as % of GDP* | 17.5 | 19.4 |
| *VI.* | *Gross Domestic Capital Formation as % of GDP* | 17.6 | 21.2 |
| *VII.* | *Inflation (Wholesale Price Index) % (average, base 1993–94=100)* | 9.0 | 8.0 |
| *VIII.* | *Money, Credit and Banking Indicators (Growth rate)* | | |
| | Money supply ($M_3$) | 17.3 | 17.2 |
| | Reserve money | 14.5 | 16.8 |
| | Aggregate deposits of SCBs | 20.3 | 18.1 |
| | Bank credit of SCBs | 18.5 | 16.8 |
| | Non-food credit of SCBs | 17.4 | 17.8 |
| *IX.* | *External Sector* | | |
| | Export/GDP ratio | 4.4 | 4.7 |
| | Import/GDP ratio | 5.6 | 7.9 |
| | CAD/GDP | –0.1 | –1.8 |

*Notes*: 1. For decadal growth in GDP and share, ten-year average was worked out, except for the growth variables, namely agriculture, industry and services for the decade 1970–71 to 1979–80, where only the nine-year average was taken due to non-availability of data for the year 1969–70 in the same series.

2. For IIP, nine-year average was taken for 1970–71 to 1979–80 and 1980–81 to 1989–90 at 1970=100 and 1980–81=100, respectively.

3. SCBs: scheduled commercial banks.

4. '–' : not available.

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

per cent over the decades under consideration. The BoP position also worsened as the CAD to GDP ratio deteriorated from (–) 0.1 per cent during the 1970s to (–) 1.8 per cent during the 1980s.

As the years progressed, despite the improved performance of the economy on the agricultural and industrial fronts, the monetary expansion and price situation called for continued vigil. One major concern was high growth in reserve money. Against this backdrop, broad guidelines were issued to the banks in May 1981 to rein in non-food credit expansion. Subsequently, however, the efficacy of supply and demand management policies resulted in achieving relative stability in the general price level. The Reserve Bank's policy stance nevertheless remained one of caution and restraint. The policy objectives aimed at promoting savings, containing inflationary expectations and ensuring adequate liquidity so that the genuine credit requirements of the productive sectors of the economy were met. Orderly management of the uncomfortable price situation and strains in the external payments were key facets of the economic performance, despite a severe drought and an unfavourable environment for external aid and trade.

The economy posted impressive growth during 1983–84, as the real GDP expanded by 7.7 per cent during the year. The price rise, however, continued to remain the core concern. The impact of the depletion of food stocks as a result of the drought was visible in the disconcerting price situation. Against the backdrop of favourable weather conditions, the agricultural strategy of reduction in the prices of fertilisers, expansion in the distribution network, increase in the irrigated area, availability of credit and distribution of quality seeds and other inputs led to the revival of agricultural output. During 1983–84, agricultural production witnessed a high growth rate of 10.3 per cent.

By the mid-1980s, there was perceptible improvement in the external sector situation. A significant development on the external payments front was that the Government voluntarily terminated the three-year EFF arrangement with the IMF from May 1, 1984, *i.e.,* about six months ahead of the date when this arrangement was to come to an end. India drew only SDR 3,900 million or SDR 1,100 million less than the amount of SDR 5,000 million initially agreed to be drawn over the three-year period ending November 8, 1984.

At the time of initiation of the Seventh Five Year Plan, the economic scenario showed promise. There was a noticeable improvement in the price situation, the food grain stock was at an unprecedented level of 29 million tonnes, the level of foreign exchange reserves was comfortable, the savings rate was high and the capital market was buoyant. The Seventh Five Year Plan envisaged sustaining a growth rate of 5.0 per cent in real national income through 1985–86 to 1989–90.

Priority sector lending had remained an important objective of banking since nationalisation. In the 1980s, the necessity to consolidate and practise sound banking caught the attention of policymakers. As a result, the 1980s saw a significant slowdown in branch expansion, and covering spatial gaps in rural areas gained prominence. Banking policy at this point emphasised providing better customer service, promoting efficiency in housekeeping, recovering dues, enhancing staff productivity and improving profitability. The Reserve Bank underscored the need to improve profitability and the viability of the banking system. The banks were strengthened and modernised, and safety and prudential issues were highlighted. Directing institutional credit flow through regulatory guidelines and directives to specified sectors characterised rural credit. The Chakravarty Committee placed an emphasis on the need for co-ordination between the banks and government agencies for successful implementation of priority sector lending initiatives and promoting a recovery culture. In initiating banking reforms, preliminary attempts were made towards deregulation of interest rates. As a first step in April 1985, the Reserve Bank freed bank deposit rates for maturities between 15 days and less than one year, with a ceiling of 8.0 per cent. The measure, however, did not have the desired effect and prompted a rate war among the banks, forcing the Reserve Bank to quickly reverse the decision.

Reforms were undertaken in many sectors of the economy during the second half of the 1980s. These included a relaxation in industrial licensing and imports. The liberalisation in the industrial policy was aimed at removing the constraints inhibiting the growth potential of the Indian industry. The measures introduced facilitated the import of technology and capital goods, aimed at modernising industry and increasing its competitiveness. The Indian industry at this stage was passing through a stage of transition from a protected to a more competitive environment. While liberalisation in respect of licensing and imports exposed the industry to intense domestic and external competition, it also improved the availability of the inputs for modernisation and technology upgrading.

Fiscal reforms were initiated in 1985–86 with a view to create a conducive environment for growth, productivity and savings, as also to promote an equitable tax system and ensure better tax compliance.

Reduction and rationalisation of the tax structure was brought about in order to impart simplicity, stability and reasonableness in the tax rates. The reforms in the indirect taxes aimed at reducing the costs of investments in the priority sector, encouraging the growth of the small scale sector and removing distortions. On the flip side, the lower-than-planned growth rate in the power sector posed infrastructure constraints. There were challenges posed by the fiscal situation. Rising debt-service obligations and the necessity for essential imports also generated uncertainties for the BoP position.

The long term fiscal policy (LTFP) was announced by the Government in December 1985 with the aim of creating an environment conducive to rapid growth in production and employment, while at the same time achieving reduction in poverty. Major components of the LTFP were steps taken to enhance the share of direct taxes in the total tax revenue over time, to rationalise the tax structure to reduce evasion and to make the fiscal system more progressive. The incidence of the indirect tax system was also sought to be made progressive through lower tax rates on essential commodities and subsidised distribution of food grain, edible oils and sugar through the public distribution system (PDS). Reforms in the tax system under the LTFP were aimed at achieving high growth with social justice, while ensuring that there were no significant revenue losses. An essential component of the LTFP was non-inflationary financing of the Seventh Five Year Plan through increased reliance on surpluses generated by the budget and the public sector undertakings (PSUs) and a corresponding decline in dependence on borrowed funds.

Efforts were made to develop the money market (as per the recommendations of the Vaghul Committee), which led to rationalisation of call money rates and the introduction of money market instruments to improve short-term liquidity in the market, besides creating the necessary institutional infrastructure for providing liquidity to money market instruments. The recommendations of the committee also resulted in the setting-up of the Discount and Finance House of India Ltd (DFHI) in 1988. The measures had a modest immediate impact, as the efficient functioning of the market was hindered by several structural rigidities at that point of time, including a skewed distribution of liquidity and the prevalence of administered deposit and lending rates.

During 1987–88, a drought of severe intensity struck, disrupting the growth process that was intended to be the result of the implementation of the Seventh Five Year Plan. There was substantial drawdown of the food stocks for maintaining supplies under the PDS. Judicious supply management through the food stock channel and resorting to higher imports of essential commodities helped alleviate the supply constraints that resulted from substantial loss of agricultural production, employment and income. Unlike the drought years in the past, when real income had actually declined, in 1987–88 real income showed positive growth. This reflected a significant structural shift in the economy, with the industrial growth maintained at a reasonable rate and the services sector contributing significantly to the growth of real income. The inflationary pressures during 1988–89 were relatively well-contained considering the earlier experience of the post-drought years being periods of high inflation.

In sum, significant changes took place in various segments of the economy in the form of reform measures, which were undertaken from time to time. The fiscal deficit, inflation rate and the external sector nevertheless remained areas of constant concern for policymakers. By the end of 1988–89, the fiscal deficit was very high, short-term borrowings were on the rise and the signs of an impending crisis began to surface.