The Mid-1960s: Crisis and Response

The significant achievements during the first three Plans notwithstanding, the Indian economy was in the grip of a massive crisis in many respects by the mid-1960s, which rapidly changed India's image from a model developing country to a 'basket case'. Two successive monsoon failures of 1965 and 1966, added to the burden on an agriculture which was beginning to show signs of stagnation, and led to a fall in agricultural output by 17 per cent and foodgrain output by 20 per cent. The rate of inflation which was hitherto kept very low (till 1963 it did not exceed 2 per cent per annum) rose sharply to 12 per cent per annum between 1965 and 1968 and food prices rose nearly at the rate of 20 per cent per annum. The inflation was partly due to the droughts and partly due to the two wars of 1962 (with China) and 1965 (with Pakistan) which had led to a massive increase in defence expenditure. The government consolidated (state and Centre) fiscal deficit peaked in 1966–67 at 7.3 per cent of GDP.

The balance of payments situation, fragile since 1956–57, deteriorated further, with foreign exchange reserves (excluding gold) averaging about $340 million between 1964–65 and 1966–67, enough to cover less than two months of imports. The dependence on foreign aid, which had been rising over the first three Plans, now increased sharply due to food shortages as well as the weakness of balance of payments. Utilization of external assistance, which was 0.86 per cent of Net National Product (NNP) at factor cost in 1951–52, increased to 1.05 per cent in 1956–57, 2.37 per cent in 1957–58, 2.86 per cent in 1960–61 and 3.8 per cent in 1965– 66. Amortisation and interest payments as percentage of exports (debt service ratio) rose sharply ftom 0.8 up to the end of the First Plan to 3.9 during the Second Plan, 14.3 during the Third Plan to 20.6 in 1966–67 and a whopping 27.8 in 1966–67. Given the overall situation, long-term planning had to be temporarily abandoned and there were three annual Plans between 1966 and 1969 before the Fourth Five Year Plan could commence in April 1969.

It was at this most vulnerable time for the Indian economy— with high inflation, a very low foreign exchange balance, food stocks so low as to threaten famine conditions in some areas, calling for large imports, and nearly half the imports having to be met through foreign aid—that the US, the most important donor at that time, decided to suspend its aid in response to the Indo-Pak war (1965) and India's stand on Vietnam and refused to renew the PL-480 (wheat loan) agreement on a long-term basis. Also, the US, in President Johnson's words, wanted to keep India 'on a short leash' so that India did not stray too much from the policies preferred by it, which they now sought to pressurize India to accept.

The US, the World Bank and the IMF wanted India to (a) liberalize its trade and industrial controls, (b) devalue the rupee and (c) adopt a new agricultural strategy. While there was considerable indigenous support for a new initiative in agriculture (which was successfully implemented), there was plenty of suspicion over trade and industrial liberalization and particularly over devaluation. As it happened, the devaluation of the rupee (nominally by 36.5 per cent though effectively much less) and the trade liberalization that was initiated by prime minister Indira Gandhi in the mid-1960s got associated with the continuing recession in industry, inflation, and the failure of exports to pick up, all of which was at least partly caused by 'exogenous' circumstances like the second major drought of 1966–67 and partly by the inadequate manner in which these policies were initiated. In any case, these policies were condemned before their long-term effect could be realized.

The perceived failure of the devaluation and liberalization of controls on trade and industry combined with the resentment at the 'arm-twisting' resorted to by external agencies in favour of these policies, using India's economic vulnerability, led to an 'economic nationalist' response based on a reversal to (and often considerable accentuation of) the earlier policies of controls and state intervention. The immediate imperative was seen to be the restoring of the health of India's balance of payments situation, creation of sufficient foreign exchange reserves and the removal of dependence on food imports by improving agricultural production and creating food reserves.

The method chosen for meeting the balance of payments crisis and reducing the fiscal deficit (the two being linked) was a severe tightening of the belt, involving drastic cuts in government expenditure rather than increases in tax levels. The cut fell mainly on government capital expenditure, which in real terms decreased by about 50 per cent between 1966–67 and 1970–71. This was an important factor in the continued industrial recession in this period. The industrial slowing down continued till the mid-1970s, the industrial growth rate coming down from an average of 7.8 per cent per year between 1951 and 1966 to 4.99 per cent per year between 1966 and 1974.

Further, the political developments in this period had important implications for economic policy. In the 1967 elections, the Congress party received a major setback at the Centre and particularly in the states. The prime minister responded by adopting a radical stance which led to differences within the Congress and eventually a split in November 1969. After the split Mrs Gandhi could retain the government only with the support of the Communist parties and some regional parties, and this accentuated the radical left turn in her policies. In December 1970, she called for a general election and, campaigning on the slogan of *garibi hatao* and promising radical socialist policies, she romped to power with a landslide victory in March 1971.

The post-1967 period therefore saw the launching of a series of radical economic policies which were to have long-term effects on India's developmental effort. Some of these policies accentuated the shortcomings that had begun to emerge during the first phase of planning itself, that is, in the 1950s and early 1960s, others created new distortions. The major private commercial banks in India were nationalized in 1969. The same year the Monopolies and Restrictive Trade Practices (MRTP) Act, severely restricting the activities of large business houses, was passed. After the 1971 election victory, a series of further such measures increasing government control and intervention were introduced with the active support of left radical intellectuals like P.N. Haksar, D.P. Dhar and Mohan Kumaramangalam. Thus, insurance was nationalized in 1972 and the coal industry was nationalized in 1973. A disastrous effort was made to nationalize wholesale wheat trade the same year, which was abandoned after a few months.

The Foreign Exchange Regulation Act (FERA) was passed in 1973, putting numerous restrictions on foreign investment and the functioning of foreign companies in India, making India one of the most difficult destinations for foreign capital in the world. The government also decided to take over and run 'sick' companies, such as a number of textile mills, rather than allow such loss-making companies to close down.

The debilitating long-term effects of many of these measures on the overall economy have been discussed later in this chapter.

It must be remembered, though, that the new policies, which were partially a result of the historically specific economic and political situation, met many of the critical problems faced by the country at that time. They pulled India out of the economic crisis most creditably and restored her independence and dignity *vis-ávis* the advanced countries. We shall briefly review these achievements in the next section.

The Achievements

In the considerable economic achievements between the mid-1960s and the end-1980s, Indira Gandhi (often too easily dismissed as populist) played a major role. These achievements are to be viewed in light of the series of formidable internal and external shocks witnessed during this period. For example, following the crisis of the mid-1960s discussed above, there was the genocide in East Pakistan (Bangladesh) resulting in the huge burden of over 10 million refugees from that region (nearly half the population of a country like Australia!) taking shelter in India, the 1971 war with Pakistan, two droughts of 1972 and 1974, the major oil shock of 1973 leading to a quadrupling of international oil prices and hence of cost of oil imports, the oil shock of 1979 when oil prices doubled, the disastrous harvest of 1979–80 caused by the worst drought since independence, and the widespread successive droughts of 1987 and 1988.

Concerted efforts were made after the mid-1960s to, *inter alia,* improve the balance of payments situation, create food security, introduce anti-poverty measures and reduce dependence on imports for critical inputs like oil. These enabled India to weather the impact of the droughts, war and the oil shocks without getting into a debt crisis and a recessionary spin as happened in the case of a number of developing countries, especially in Latin America in the 1980s, and without serious famine conditions, let alone the huge number of famine deaths that occurred in Communist China in the late 1950s.

On the food front the situation improved rapidly. The adoption of the Green Revolution strategy of introducing a package of high-yield variety (HYV) seeds, fertilizers and other inputs in a concentrated manner to some suitable select areas paid immediate dividends in creating food security and poverty reduction. Between 1967–68 and 1970–71 foodgrain production rose by 35 per cent. Net food imports fell from 10.3 million tonnes in 1966 to 3.6 million tonnes in 1970, while food availability increased from 73.5 million tonnes to 89.5 million tonnes over the same period. Food availability continued to increase sharply to 110.25 million tonnes in 1978 and 128.8 million tonnes in 1984 and food stocks crossed the 30 million tonnes mark by the mid-1980s, putting an end to India's 'begging bowl' image and creating considerable food security even to meet extreme crisis situations. For example, the economy was able to absorb the massive successive droughts of 1987–88 without undue pressure on prices of food or imports. In fact, the rural poverty index continued to show a decline in these crisis years as rural employment and incomes were maintained through government programmes using the surplus food stocks. This was the first time since independence that rural poverty was not exacerbated during a drought or a poor harvest.

Apart from food self-sufficiency, certain other features emerged that pointed towards a greater autonomy of the Indian economy and increased self-reliance. The fiscal deficit was brought down sharply from 7.3 per cent of GDP in 1966–67 to 3.8 per cent in 1969–70. The balance of payments situation improved considerably with reduced food and other imports, a certain improvement in exports and particularly with the surge in remittances made by Indian workers from the oil-boom rich Middle East. By 1978–79, foreign exchange reserves had risen to a peak of about $7.3 billion (including gold and SDKs), more than nine months of imports cover compared to the less than two months covered in 1965–66.

Given the arm-twisting of the donors, self-reliance was seen as the need to reduce dependence on foreign aid not only in crisis situations such as those created by drought or other natural disasters, but also on aid as a short-term means to develop key capabilities, as was envisaged in the earlier Nehru–Mahalanobis strategy. Partly as a result of this shift in perspective, foreign aid began to decline rapidly. Net aid as a proportion of NNP, which had peaked to an average of 4.22 per cent during the Third Plan (the last few crisis years of the Plan partly accounting for this high rate), came down to 0.35 in 1972–73 and rose only slightly after the 1973 oil crisis, but yet averaged not more than 1 per cent of NNP till 1977–78. The debt service ratio, that is, the annual outflow of interest and repatriation of principal due to existing debt as a proportion of exports of goods and services, fell to a low and easily manageable 10.2 per cent in 1980–81 from an estimated 23 per cent in 1970– 71 and 16.5 per cent in 1974–75.

We have already seen that the rapid expansion in the indigenous capital goods industry, which started in the Nehru years, had greatly reduced India's dependence on the external world for maintaining her rate of investment (and growth) as the share of equipment that needed to be imported in the total fixed capital investment in India had fallen from 43 per cent to 9 per cent between 1960 and 1974.

Private foreign investment continued to be very low in proportion to total investment. Unlike many Latin American and some East Asian countries, foreign capital or multinational corporations played a very minor role in India. In 1981–82, only about 10 per cent of value added in the factory sector of mining and manufacturing was accounted for by foreign firms which included FERA companies with diluted foreign shareholding. Till the 1980s, most foreign collaborations were technological collaborations not involving any foreign share or equity capital. For example, in 1977–80, 86.5 per cent of technology import agreements did not involve any foreign equity. Foreign capital was marginal in the financial sphere as well. It was negligible in the insurance sector and foreign banks accounted for only 8.9 per cent of total deposits in the organized banking sector in 1970. Between 1969 (the year of bank nationalization) and 1981, while the number of branches of all commercial banks in India rose from 8,262 to 35,707, the number of branches of foreign banks rose from 130 to 132. By 1992, the corresponding figures were 60,601 and 140. (It may be noted here, as an aside, that more than 60 per cent of the massive branch expansion of the Indian banks was in the rural areas, not only creating a much wider base for mopping up savings but also for extending credit, and thus enabling priority credit to agriculture, and that too increasingly to the poorer households as part of the second wave of land reform and the *garibi hatao* campaign.

Thus, while the volume of foreign private investment remained marginal and foreign aid declined and the ratio of foreign savings to total investment fell and remained low throughout the 1970s, the rates of domestic savings and investment increased rapidly. As Table 26.1 shows, from an average savings rate of 10.58 per cent and a rate of Gross Domestic Capital Formation or investment of 11.84 per cent in the 1950s, the savings and investment rates nearly doubled to 21.22 per cent and 20.68 per cent respectively between 1975–76 and 1979–80. The 1980s and 1990s saw further increases in the rates of domestic savings and capital formation, making them comparable to several high-growth economies.

A new feature of the 1980s was the phenomenal increase in new stock market issues, the stock market thus emerging as an important source of funds for industry. It has been estimated that in 1981 the capital market accounted for only 1 per cent of domestic savings, whereas by the end of the 1980s this proportion had increased by about seven times. The new stock issue in 1989 was Rs 6,500 crore, which was about 7.25 per cent of Gross Domestic Savings of 1989–90. Another estimate shows that in 1990 Indian companies raised an unprecedented Rs 12,300 crore from the primary stock market.

Table 26.1: Gross Domestic Savings and Gross Domestic Capital Formation

(As per cent of GDP at current market prices)

Annual Average	*Gross Domestic Savings*	*Gross Domestic Capital Formation (Adjusted)*
1950–51 to 1959–60	10.58	11.84
1960–61 to 1969–70	13.53	15.63
1970–71 to 1979–80	18.92	19.06
1975–76 to 1979–80	21.22	20.68
1980–81 to 1989–90	20.03	21.99
1990–91 to 1995–96	23.80	25.35

Source: Calculated from Economic Survey, 1996, Government of India.

The early 1980s also saw a highly successful breakthrough in the import substitution programme for oil under the supervision of the Oil and Natural Gas Commission (ONGC), a public sector organization. The large loan received from the IMF in this period helped this effort considerably. In 1980–81, domestic production of oil was 10.5 million tonnes and imports 20.6 million tonnes, the oil import bill taking up 75 per cent of India's export earnings! With new oil finds at the Bombay High oil fields, by the end of the Sixth Plan (1980–85), the target of indigenous production of 29 million tonnes was achieved. As a result, in 1984–85, the net import of oil and oil products was less than a third of the domestic consumption and the oil import bill was also down to a third of export earnings.

By the mid-1970s, the industrial growth rate also started picking up from a low of about 3.4 per cent between 1965 and 1975 to about 5.1 per cent between 1975 and 1985. If the crisis year of 1979–80 was omitted, then the industrial growth rate during 1974– 75 to 1978–79 and 1980–81 to 1984–85 was about 7.7 per cent per annum. In the 1980s as a whole the industrial growth rate maintained a healthy average of about 8 per cent per year. Again it was in the 1980s that the barrier of the low, so-called 'Hindu rate of growth' of 3 to 3.5 per cent that India had maintained over the previous two decades was broken and the economy grew at over 5.5 per cent. By one estimate the average real GDP growth rate between 1980 and 1989 was an impressive 6 per cent.[1]

Long-term Constraints: The Need for Reform

While on the one hand the Indian economy in the 1980s seemed to be doing quite well, on the other hand there were certain long-term structural weaknesses building up which were to add up to a major crisis by 1991 when the country was on the verge of defaulting. It is this crisis which brought home to the country the immediate necessity of bringing about structural adjustment and economic reforms.

Broadly, there were three sets of problems which had gathered strength in the Indian economy over time and which needed urgent reform.

The first set of problems related to the emergence of structural features that bred inefficiency. The import-substitutionindustrialization (ISI) strategy based on heavy protection to indigenous industries was, as we saw earlier, very effective in deepening and widening India's industrial base and giving the economy a lot of freedom from foreign dependence. However, over time, the excessive protection through import restrictions started leading to inefficiency and technological backwardness in Indian industry.

This situation was further accentuated by the so-called 'Licence Quota Raj', that is, a whole plethora of rules, regulations and restrictions which stifled entrepreneurship and innovation. The MRTP Act and the reservation of sectors for small-scale industry are cases in point. The MRTP Act went against the basic principle of economies of scale, which is at the heart of capitalist development (or for that matter of socialist production). It also punished efficiency, as any company which expanded due to efficient production, good management and research and development (R&D), would face severe restrictions, including refusal of permission to increase capacity once it crossed a prescribed limit. It has been pointed out that the combination of the ISI strategy focusing on the domestic market together with restrictions on large industry from fully exploiting the domestic market through MRTP restrictions was particularly damaging for growth. Industry could neither expand in the domestic market nor were the ISI policies encouraging them to exploit foreign markets.

Again, reserving certain areas (the list kept growing) for small-scale industries meant excluding these areas from the advantages of scale and larger resources for R&D activities. This made the sector often internationally uncompetitive, leading to India losing out to its competitors in many areas. Also, the policy towards small-scale industry forced entrepreneurs in the reserved areas to remain small, as any expansion as a result of efficient and profitable functioning would deny the enterprise the special incentives and concessions. This inhibited efficiency and innovation in this sector. Further, industrial licensing cut off domestic competition just as import control cut off external competition and the two combined left little impetus for indigenous industry to be efficient.

The large public sector in India, which controlled 'the commanding heights' of the economy, also began to emerge as a major source of inefficiency. The early emphasis on the public sector was critical to India's industrial development. It is the public sector which entered the core areas, diversified India's industrial structure, particularly with regard to capital goods and heavy industry, and reduced India's dependence on foreign capital and foreign equipment and technology. However, over time, political and bureaucratic pressure on the public sector undertakings gradually led to most of them running at a loss. They were overstaffed, often headed by politicians who had to be given sinecures, became victims of irresponsible trade unionism and were unable to exercise virtually any efficiency accountability on their employees. State-run utilities like electricity boards and road transport corporations were notorious for incurring enormous losses. Apart from rampant corruption and lack of accountability, these enterprises, under populist pressure, often charged rates that did not cover even a small fraction of the actual costs. The extreme case of course was of the recent (1997) Punjab government decision to distribute electricity *free* to farmers! Even the critical banking and insurance sectors, which after nationalization had expanded phenomenally, mopping up huge resources, soon began to suffer from the public sector malaise of inefficiency and political interference. Many banks started running at a loss and the insurance sector remained inefficient and covered only a fraction of its enormous potential market.

Licensing, MRTP Act, small-scale reservation and the like made entry or expansion of business very difficult; since the mid-1970s virtually no exit was possible for inefficient loss-making companies as they could not close down or retrench without government permission. Powerful trade unions, which had led to a dramatic increase in collective bargaining, the index number of man-days lost rising from 100 in 1961 (base year) to 891.6 in 1980, made such closures very difficult. The government ended up taking over many 'sick' companies which otherwise needed to be closed down— the National Textile Corporation which took over a number of 'sick' textile mills becoming a major contributor to the total losses incurred by the public sector.

All this led to the investment efficiency in India being very low or the capital-output ratio being very high. A 1965 study shows that the public sector Heavy Electricals Limited was set up in

Bhopal with a capital-output ratio of between 12 and 14—with no questions being asked or enquiry set up! Though this is an extreme case, estimates for the economy as a whole show that the capital used per unit of additional output or the incremental capital-output ratio (ICOR) kept rising, it being a little over 2 during the First Plan and reaching 3.6 during the Third Plan. According to one estimate, between 1971 and 1976 the ICOR had touched a high of 5.76. This explains why despite substantial increases in the rate of investment (see Table 26.1) there was an actual decrease in the overall growth rates of aggregate output or GDP between the 1950s and 1970s. The ICOR started declining in the 1980s though it still remained around 4 in the 1990s. Even during the 1980s, one estimate shows that the (simple) average rate of financial return on employed capital in public sector enterprises was as low as 2.5 per cent. Actually, the rate of return was much lower if the fourteen petroleum enterprises were excluded, as these accounted for 77 per cent of the profits in 1989–90.

The controls, restrictions, interventions etc., discussed above were paradoxically often resorted to in the name of introducing 'socialist' principles and equity but actually ended up building a distorted, backward capitalism, as they went against the basic laws of capitalism such as the need for continuous expansion on the basis of innovation and efficient investment. Low efficiency or low productivity levels are of critical consequence in today's 'postimperialist' world, where economic superiority is established and transfer of surplus from one country to another occurs not through direct political or economic domination but through processes such as unequal exchange occurring between countries with different productivity levels. Economic thinkers of the left and the right are agreed on placing the question of productivity at the centre of any national development. In today's context of rapid globalization, pursuing excessively autarchic policies in search of autonomy (something a section of the Indian left and the newly discovered Swadeshi path of the right, such as the RSS, still argues for) may, through fall or stagnation of productivity levels, destroy precisely that autonomy and push the country towards peripheralization.

This brings us to the second set of weaknesses that emerged in the Indian economy and which relate to the continuation of the inward-oriented developmental path followed by India since independence. India failed to make a timely shift from the export pessimism inherent in the first three Plans, a pessimism which, one must recognize, was shared widely by development economists the world over in the 1950s. The failure lay not in adopting the policies that emerged from the wisdom of the 1940s and 1950s but in the inability to quickly react to changes occurring in the international situation and to world capitalism after the Second World War, particularly since the 1960s and 1970s.

Some of the important changes that needed to be taken cognizance of are mentioned here: first, the nature of foreign capital and multinational corporations was changing. A process of 'internationalization of production' had started. Multinational corporations, instead of just looking for markets or sources of raw material, now looked for cheaper production areas. Instead of creating enclaves in the backward countries, which had backward and forward linkages with the home country (this was the typical colonial pattern), they were now bringing in investments which had major multiplier effects on the local economy, including of technology transfer. It became common for multinational companies to ‘source’ a large part of the components that went into the final product from all over the developing world and even shift entire production plants to the developing countries. Then, along with, and partially as a result of, the above process, there were massive capital transfers between countries, reminiscent of the capital transfers of the nineteenth century at the height of colonial expansion, but very different in character. The above two processes contributed to another major international development, that of an unprecedented explosion of world trade. Between the 1950s and 1970s, world output of manufactures increased four times but world trade in manufactures increased ten times. The percentage of world produce that went for export doubled between 1965 and 1990. What is most significant is that while there was a massive increase in global industrial exports, the Third World was able to rapidly increase its share of total industrial exports, especially since the 1970s, from about 5 per cent in 1970 to double the figure in 1983.[2]

The East Asian Miracle, that is, the rapid industrialization of the East Asian countries, beginning in the 1960s, which gradually shifted the industrial base of the world from the West to the East, took advantage precisely of these kinds of opportunities of capital and market availability. Japan’s example of explosive post-Second World War growth was being repeated by South Korea, Taiwan, Singapore, Hong Kong and, more recently, Thailand, Malaysia, China and Indonesia. The four Asian Tigers, South Korea, Hong Kong, Singapore and Taiwan increased their share in world export of manufactures from 1.5 per cent in 1965 to 7.9 per cent in 1990. Even the newly industrializing economies (NICs), Indonesia, Malaysia and Thailand increased their share from 0.1 per cent to 1.5 per cent over the same period.[3] South Korea’s manufactured exports, which were negligible in 1962, amounted to four times those of India by 1980. Again South Korea was exporting $41 billion worth of manufactured goods to the OECD countries in 1990 to India’s mere $9 billion.

India did reasonably well till the mid-1960s, basing herself on an inward-oriented, import-substitution-based strategy. However, India failed to respond adequately to the new opportunities thrown up by the changing world situation despite the availability of the East Asian experience. In fact, after the crisis of the mid-1960s, India got pushed by immediate circumstances to take a tighter ‘protectionist’ and inward-looking turn in the late 1960s and early 1970s instead of taking advantage of the globalization process.

In fact, the restrictions on multinational corporations and suspicion of foreign capital increased in this period. No advantage could be taken of the internationalization of production and of the increased international flow of funds. As for exports, though successful efforts were made to diversify them, both in terms of commodity composition (e.g., the rapid shift to manufactured exports, it being 50 per cent of total exports in 1980–81 rising to 75 per cent in 1989–90) and in terms of geographical spread, the quantitative expansion or the increase in volume of exports lagged far behind the potential created by the world expansion of trade, which was successfully exploited by the East Asian countries. In fact, India’s share in world exports actually shrank from about 2.4 per cent in 1948 to 0.42 per cent in 1980, rising to a still paltry 0.6 per cent by 1994. The volume of India’s manufactured exports in 1980–81 was half that of China’s, one-third of Brazil’s and a quarter of South Korea’s.

India was thus unable to use the opportunities provided by the changed world situation to rapidly industrialize and transform its economy, increase income levels and drastically reduce poverty levels, as did many of the East Asian countries. South Korea, for example, had a per capita income level comparable to India's in the 1960s (based on purchasing power parity) and today South Korean income levels are knocking at the doors of levels achieved by advanced countries, while India is still pretty much near the bottom of the heap. Even China changed track in 1978, opening up its economy, participating in the globalization process, welcoming foreign investment, pushing up its exports, and so on, leading to a current growth rate much higher than India's. Between 1980 and 1989, China's real GDP, by one estimate, grew at an average rate of 9.4 per cent, considerably faster than did India's over the same period. Though the figures for China are not fully reliable, yet economists agree that China was well ahead of India in this respect.

One may add here that India's poor growth in exports had implications regarding the productivity levels achieved in the country. In fact, countries like Japan and South Korea have effectively used export obligation on the part of various enterprises as a mechanism of enforcing international competitiveness through maintenance of high productivity levels. Enterprises or business houses which failed to meet the export obligation because of lack of competitiveness were blacklisted and suffered serious consequences, sometimes leading to bankruptcy.

The third set of problems which overtook the Indian economy were primarily the result of certain political imperatives, and which were related to the manner in which the Indian state structure and democratic framework evolved. More and more sections emerged which made strong, articulate demands on state resources. Governments, however, were increasingly unable either to meet these demands fully or diffuse the clamour for them. This resulted in the gradual abandoning of fiscal prudence from about the mid1970s. A situation was created where the macroeconomic balance, which was maintained in India (unlike many other developing countries) with great caution for the first twenty-five years or so after independence, was being slowly eroded. The macroeconomic imbalance that now emerged tended to be long term and structural in character as distinct from the short-term imbalances created by shocks such as those of the mid-1960s or the 1970s, related to oil.

The gradual erosion of fiscal prudence was reflected in government expenditure rising consistently, mainly because of the proliferation of subsidies and grants, salary increases with no relationship to efficiency or output, overstaffing and other 'populist' measures such as massive loan waivers. Growing political instability and political competition, as the Congress party's sole hegemony began to erode, led to competitive populism with each party trying to outdo the other in distributing largesse. Also, it has been argued that with the prestige of Congress waning, it was no longer able to stand above competing groups pressing for an immediate increase in their share of the national cake and rein them in with the promise of rapid growth and a just income distribution in the future if current demands were subdued. Further, with Mrs Gandhi increasingly centralizing power in her hands, democratic functioning within the Congress party declined, with the party gradually losing its organizational links with and control over the grassroots. Political bargaining between sections of society was now not done within party structures but through budget allocations. Lastly, with parties clearly representing sectional interests, such as those of the rich and middle peasants, coming to power in several states after the 1967 elections and even beginning to have a say in the Centre after 1977, huge budgetary allocations were often made which were in the nature of sectional subsidies at the cost of an expenditure pattern best suited to overall development.

How did these political imperatives translate into real economic terms? As we saw earlier, the, response to the mid-1960's crisis was fiscal and balance of payments caution. However, a certain relaxation of fiscal discipline began after 1975 and particularly during the Janata regime of 1977–79. Food subsidies doubled between 1975–76 and 1976–77 from Rs 2.5 billion to Rs 5 billion. The fertilizer subsidy multiplied ten times from Rs 0.6 billion in 1976–77 to Rs 6.03 billion in 1979–80. The export subsidy multiplied by about four and a half times from Rs 0.8 billion to Rs 3.75 billion between 1974–75 to 1978–79. During 1977–79 (the Janata period) procurement prices for foodgrains were increased without corresponding increases in issue prices, taxes on a wide range of agricultural inputs were decreased and budgetary transfers to loss-making public sector units increased. In fact, the 1979 budget has been described by eminent economists Vijay Joshi and I.M.D. Little as a 'watershed marking the change from previous fiscal conservatism'.[4]

The fiscal profligacy continued through the 1980s and particularly during the second half, reaching absurd limits where, for example, the V.P. Singh-led National Front government that came to power in 1989 announced a loan waiver for farmers which would cost the exchequer more than Rs 100 billion. The direct subsidies from the central budget on only food, fertilizer and exports in 1980–81 have been estimated to exceed Rs 15 billion, an amount equal to half of the total gross capital formation in manufacturing in the public sector that year! While there was this explosive growth of government spending, the savings generated by the government or public sector kept falling with their growing losses. The result of fiscal profligacy was that the consolidated government (Centre and states) fiscal deficits rose sharply from 4.1 per cent of GDP in 1974–75 to 6.5 per cent in 1979–80, 9.7 per cent in 1984–85, peaking at 10.4 per cent in 1991. Governments in this period tended to seek ways and means of increasing their domestic and foreign borrowing to meet this deficit rather than either trying to increase government savings or reduce government expenditure. In fact, the gap between public (government) investment and public savings widened threateningly. After the crisis of mid-1960s the gap had been brought down to 3.6 per cent of GDP between 1968– 69 and 1971–72, but rose to 5.3 per cent in 1980–81 and 9 per cent by 1989–90.

The growing government saving–investment gap and the fiscal deficit had a negative impact on the balance of payments and debt situation. From a situation of balance of payments surplus on the current account in 1977–78 of $1.5 billion (1.4 per cent of GDP), by 1980–81 there was a deficit in the current account to the tune of $2.9 billion (1.7 per cent of GDP). The deficit increased to $3.5 billion (1.8 per cent of GDP) in 1984–85 and rose very sharply thereafter to $9.9 billion (3.5 per cent of GDP) in 1990–91. It must be noted that the rapid worsening of the balance of payments situation, especially in the late 1980s, was neither due to any major external shock nor due to import liberalization. In fact, the second half of the 1980s saw an actual improvement in trade balance with exports growing rapidly at an average of about 14 per cent per year in dollar terms. The overall economy's savings– investment gap which had risen to an average of about 2.5 per cent of GDP between 1985 and 1990 (as the huge public savings–investment gap could not be fully compensated by the substantial excess of household and private corporate savings over private investment) and the consequent necessity of heavy borrowing had caused the balance of payments deficit.

It must be noted that the 1980s were a period of high growth. Between 1985 and 1990, on an average, India's GDP grew at over 5.5 per cent per year, industry at over 7 per cent, capital goods at 10 per cent, consumer durables at 12 per cent and so on. However, this growth was not a result of any step-up of savings and investment; in many ways it was a result of over-borrowing and overspending. The growth was both debt led (like Latin America of the 1970s) and the result of an explosion of domestic budgetary spending. This kind of growth was naturally not sustainable as the macroeconomic imbalances were bound to reach a point where a crash could no longer be averted—as happened in Latin America in the 1980s and in India almost a decade later.

The deteriorating fiscal and balance of payments situation had led to a mounting debt problem, both domestic and foreign, reaching crisis proportions by the end of the 1980s. Total government (Centre and state) domestic debt rose from 31.8 per cent of GDP in 1974– 75 to 45.7 per cent in 1984–85 to 54.6 per cent in 1989–90. The foreign debt situation also became very precarious with debt rising from $23.5 billion in 1980–81 to $37.3 billion in 1985–86 to $83.8 billion 1990–91. The debt service ratio (i.e., payment of principal plus interest as a proportion of exports of goods and services) which was still a manageable 10.2 per cent in 1980–81 rose to a dangerous 35 per cent in 1990–91. Moreover, the proportion of concessional debt to total debt also fell from over 80 per cent to about 40 per cent in this period, that is, increasingly, the debt consisted of short-term commercial borrowing. The prejudice against foreign direct investment (FDI), which still remained, led to this excessive dependence on foreign debt rather than foreign equity capital, and inadequate returns on the borrowings led to an unsustainable debt service burden.

India's foreign exchange reserves fell from $5.85 billion in 1980–81 to $4.1 billion in 1989–90, and in the next year (1990– 91) they fell drastically by nearly half to $2.24 billion enough only for one month's import cover. The Iraqi invasion of Kuwait in August 1990, leading to an increase in oil prices and a fall in Indian exports to the Middle East or Gulf region, partly contributed to this alarming foreign exchange situation. India's international credit rating was sharply downgraded and it was becoming extremely difficult to raise credit abroad. In addition, non-resident Indian (NRI) deposits in foreign exchange began to be withdrawn rapidly. In such a situation, where foreign lending had virtually dried up, the government was forced to sell 20 tonnes of gold to the Union Bank of Switzerland in March 1991 to tide over its immediate transactions. By July 1991 foreign exchange reserves were down to a mere two weeks' import cover despite loans from the IMF. The country was at the edge of default.

This is the situation (June 1991) in which the minority Congress government of Narasimha Rao took over power and with Manmohan Singh as finance minister attempted one of the most important economic reforms since independence.