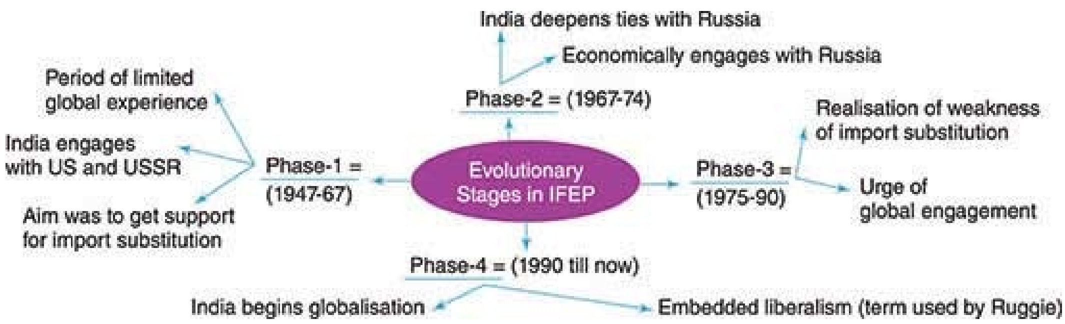
6 CHAPTER

India's Foreign Economic Policy

After reading the chapter, the reader will be able to develop an analytical understanding on the following:

- Core actors in India's Foreign Economic Policy
- Sketch of evolutionary stages
- Idea domination and change model
- Phase 1 – 1947 to 1966
- Phase 2 – 1967 to 1974
- Phase 3 – 1974 to 1990
- Phase 4 – 1990 till now

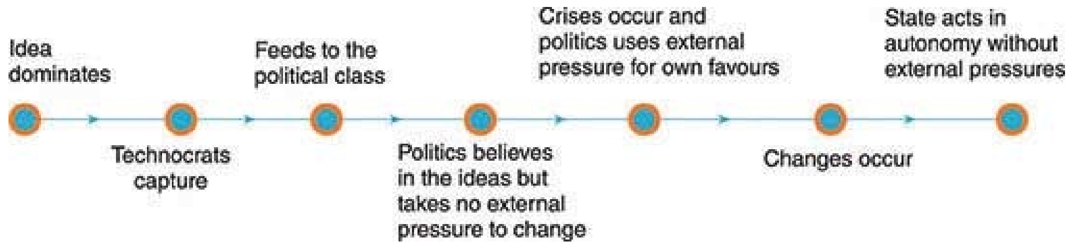
India's Foreign Economic Policy (IFEP) has developed over a period of time during the Cold War. The Indian Prime Ministers at the helm have had a deep imprint in moulding the IFEP. The national leaders ended up creating and evolving the present IFEP by analysing the interaction of economic actors and politics. As the state of India progressed domestically, its interaction with its external environment increased, leading to several encounters that left an imprint on its economic foreign policy.



Before we attempt our study of IFEP, we must understand how ideas and the state interact to create economic leverage. A state develops certain national interests, which must necessarily include an economic component, depending upon the present circumstances of the state's domestic affairs. For instance, when India became independent, the domestic principle in our state made it mandatory to opt for a closed economy and undertake import substitution. This idea of this domestic economic paradigm continued till 1975. However, by 1975, it was clear that the results of this strategy of import substitution was not what India had envisaged for itself. Consequently, the idea from 1975 to 1990 was to adopt an export-led growth strategy. This period was followed by an opening of Indian economy to complete the cycle of integration with the world. Thus, state policy architecture and its ideas shall always dominate economic foreign policy at all times.

In India, change in the economic paradigm is brought about by ideas and crises. In

1991, by when import substitution strategy had clearly failed to bear fruit, the Balance of Payments (BOP) crises paved way for a change to export oriented liberalisation and globalisation-based strategy.

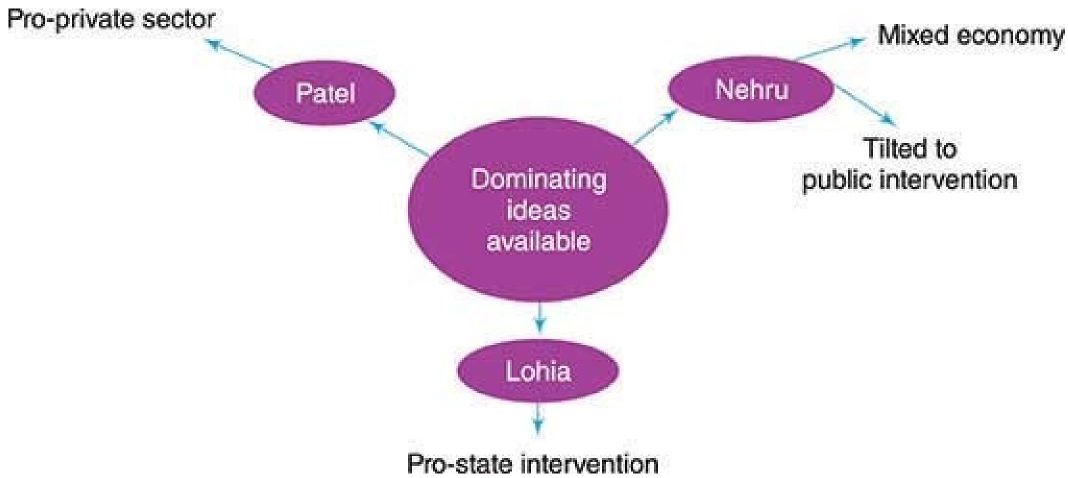


Thus, if we need to understand the interests of the Indian state, we need to perceive the core ideas of the state that are dominating at the moment. Secondly, the Indian state expresses a unique behaviour of getting from the world what they need on the basis of the ideas/goals they have set for themselves. When the Indian state adopted closed economic model, it exploited the global actors to get resources for its import substitution model. When, in 1990s, it adopted globalisation, it advocated for investment, heavily promoting sympathy for its own concerns.

Now, let us try to apply the logic derived above in the four phases outlined further ahead.

PHASE I: 1947 TO 1966

This period is where India undertook limited global exposure at the economic level. The state pursued the ideology of non-alignment and import substitution. The idea was to maintain independence in foreign policy decision making and have engagement with those who can support us in import substitution. India engaged with both the US and the USSR in this regard. Both nations, in different ways, supported import substitution.



After the death of Sardar Vallabhbhai Patel in 1950, Nehru took the decision to incline the Indian state towards state intervention. The Second Five Year plan in India and the passage of the Industrial Development and Regulation Act 1958 laid the foundation of import substitution and a closed economy. As the idea of import substitution dominated, despite multiple ups and downs, ideational changes were not entertained. For instance, after the Second Five Year Plan was launched in 1956, a BOP crisis emerged. India still resorted to channelling resources to sustain the plan that posed challenges to an open economy. The World Bank tried to push India to undertake liberalisation, but India resorted to even more import substitution after 1966. Since the dominant idea behind this policy was not unjust, India did not displease any power between 1950 to 1955.

The US, in fact, provided 500 million dollars in aid to India in that period. Nikita Khrushchev, who visited India in 1955 and appreciated its Second Five Year Plan, announced an aid for heavy industrial development. The USSR also provided assistance for the Bhillai Steel Plant. Perceiving the strong USSR support to India, the US began to fear that India might be sorely tempted to join the Soviet Camp, and consequently, from 1957 onwards, it increased its aid to India. In 1960, the US provided 800 million dollars in aid and low-priced wheat under PL-480 for tackling food shortages in India. As wheat came under PL-480, it eased out immediate shortage concerns we had but the bigger issue was that India had neglected its agriculture and had inclined too much towards rapid industrialisation.

The decade of 1960s did not augur well for India. The war of 1962, then of 1965 were followed by successive droughts in India. Perceiving the dire situation, the US began to use aid levers to push India to open its economy. The US not only urged India to open its economy but also to increase spending in agriculture and undertake a devaluation of its currency. India perceived it as interference deemed that the idea of US to open Indian economy was not a best choice at that moment. It did, however, found the idea to increase spending in agriculture to mitigate drought and establish balance between agriculture and industry to be profoundly logical, and therefore continued with import substitution with a focus on agriculture. India laid the foundation for Green Revolution to achieve self-sufficiency in agriculture. Thus, this phase proves what we observed earlier. Only when India is convinced of the total failure of an existing policy does it bring change, else the idea continues.

PHASE II: 1967 TO 1975

Two factors dominate this phase. The first is India's growing proximity to the USSR in this period. The reason for this proximity is India's search for a security guarantor. The 1971, the conclusion of the India–USSR Treaty of Friendship fulfilled the space hitherto left unoccupied by India's security dilemma as the USSR emerged as its primary security guarantor. This led India to explore an option for barter trade with the USSR to curtail forex. India also resorted to strengthening of the idea of import substitution. India opened up to the deal to have arms in exchange for wheat with the USSR at the barter level. The second factor was the strengthening of import substitution infrastructure saw the passage of the Monopolistic and Restrictive Trade Practice (MRTP) Act 1969 to regulate companies worth over 200 million Indian rupees or more. It also saw the passage of the Foreign Exchange Regulation Act (FERA) in 1973, aimed at reducing permissible equity in a firm owned by a foreign entity to 40% from the then-existing 51%. This phase also saw the nationalisation of banks. Consequently and naturally US aid dipped but proximity to USSR increased.

PHASE III: 1975 TO 1990

During this period, a gradual understanding began to emerge about the failure of import substitution delivering the needed results. A need for change was keenly felt. The government began authorising studies. The studies, which claimed that the utility of import substitution was declining and the FDI and the private sector were needed for the economy to progress further, played a role in hastening the shift being planned by the government. If we observe this phase carefully, we may see the merging ideational shift in Indian policy making. Some autonomy was given in select sectors like IT and Pharmacy and the MRTP was amended to take 200 million Indian rupees to one billion Indian rupees. However, the ideational change in the government and its policy making was muting some resistance. The government was preparing for controlled liberalisation and for the participation of foreign investment but domestic industrial class continued to hold enormous privilege and power. Apart from internal issues, the external environment towards late 1970s was not conducive as the détente between the US and the USSR failed when the latter invaded Afghanistan in 1979.

India's refusal to condemn Soviets for the Afghan invasion distanced India from the US and as the USSR got more and more preoccupied with Cold War politics, it could not provide India the needed leverage for change. Thus, despite domestic changes emerging in the form of ideas, the Cold War and domestic irritants posed immense problems in the execution of those reforms.

PHASE IV: 1990 TILL NOW

The situation in 1991 brought India at a veritable tipping point. Domestic factors like opposition from industry did not allow reforms to proceed. Moreover, as the USSR collapsed, India witnessed another BOP crisis again in the same year. The India state took the opportunity to bring the needful reforms. The fall of the USSR gave India not only in option to open up to the US and its allies but also do away with the anti-market rhetoric and go with a market order with maintenance of its own domestic autonomy. India began to open up with the US at the trade level and finally opened its economy. India also engaged with the ASEAN, Japan and South Korea. In fact, India began to reduce receiving economic aid and instead began to give out aid.

Strategic Consequences of India's Economic Performance vis-à-vis Indo–Pak Relations

During the Cold War period, especially from 1950 to 1980, when India had a GDP growth rate of 3.5%, Pakistan surprisingly had a six percent growth. However, despite a higher GDP growth rate, India neutralised Pakistan effectively during armed conflicts. Things began to change by the end of the Cold War. Pakistan slipped to 4% growth as India rose to 6% in 1990s. India began to make improvements in Human Development while Pakistan dwindled. The economic divergence in the two has compelled the strategic communities to de-hyphenate the two countries in the region. As the economic situation of India improves, it will be able to strengthen its military while the opposite will happen for Pakistan. Pakistan spends more of its budget on defence, without having a strong economy. The strategic calculus will change and it will shift the regional power dynamic. Pakistan tried neutralising its economic slide by adopting nuclear weapons and resorting to cross-border terrorism. In the long run, as Pakistani economy declines, it will not be able to sustain the cross-border terrorism campaign either. India foresees that this would compel Pakistan to normalise relations with India while it takes time to focus on rebuilding its economy. India, in the meantime, has increased bilateral regional integration to reap rich benefits and hopes that a day will come when the only remaining impediment to complete regional integration will be Pakistan, which will, in turn, compel Pakistan to normalise relation and undertake cooperation again.