

Pathways Through Financial Crisis: India



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India survived near-crisis situations twice in the 1990s. How did internal and external constraints shape that country's ability to respond to the crises? This article argues that India's success can be attributed to four sets of decisions taken during the period 1991–1997: devaluation, involvement of the IMF, partial liberalization of the domestic financial sector, and gradual opening up of the external sector. The article analyzes the options, political opposition, and eventual outcomes for each set of decisions. India's ownership of its reform program helped set the pace of reform, while close interaction between technocrats and the IMF added credibility. But the balance between entrenched traditional interest groups and the demands of new interests determined the scope of reform. **KEYWORDS:** India, financial crisis, economic reform, IMF, interest groups.

India survived near-crisis situations twice in the 1990s, and in 1991 was nearly bankrupt. In response, a reform process began. Engagement with the International Monetary Fund (IMF) had its risks: if India could not deliver on its promises of economic reform, investors would exit again; if the government pushed too hard on reforms, domestic opposition would become unmanageable. In 1997–1998 the Asian financial crisis again threatened India. Macroeconomic fundamentals were vastly different, but political instability and external shocks were common in both episodes. How did internal and external constraints shape India's ability to handle financial crises in the 1990s?

The 1991 Crisis

In 1991, India experienced a classic external payments crisis: high fiscal and current account deficits, external borrowing to finance the deficits, rising debt service obligations, rising inflation, and inadequate exchange rate adjustment. In 1979, the oil shock, agricultural subsidies, and a consumption-driven growth strategy had pushed up the fiscal deficit. It further increased in the mid-1980s as defense expenditure was substantially increased and direct taxes were progressively reduced.¹ The result was that the deficit ballooned from 1985 to reach 9.4 percent by 1990–1991.²

India's current account position also worsened. Increasing dependence on foreign oil imports, vulnerability to oil price fluctuations, declining remittances from abroad, strong domestic demand (a result of public sector wage increases in the mid-1980s), and rising debt service payments ensured that the current account deficit averaged 2.2 percent of gross domestic product (GDP) during 1985–1990. Also, export competitiveness was adversely affected by the rupee's steady appreciation: 20 percent between 1979 and 1986.³ In 1987 it steadily depreciated, but the real exchange rate remained overvalued until 1991.

To finance the twin deficits, India relied on external funds. Foreign investment at 0.1 percent of GDP during 1985–1990 was negligible.⁴ During 1980–1985, nearly half of external financing needs were met by external assistance.⁵ By the mid-1980s, “aid weariness” forced the government to rely more on commercial borrowing.⁶ Soft loans declined in proportion from 89 percent (1980) to 35 percent (1990).⁷ Thus, external debt (with a large proportion of short-term debt) started dominating the balance sheet, peaking at 38.7 percent of GDP in 1991–1992, with the debt-export ratio at 563 percent.⁸

Notwithstanding the weakening fundamentals, one key factor that reduced vulnerability was the absence of private sector external debt. Unlike many other countries, individuals and firms could not raise foreign currency-denominated debt, and the banking sector was not allowed to hold financial assets abroad. One effect of this was that the private sector's interests were geared more toward internal deregulation than toward external liberalization.⁹

Two immediate external shocks contributed to the large current account deficit of 3.1 percent in 1990–1991. First, the Gulf crisis in August 1990 exposed the Middle East's strategic relevance for India. Petroleum import costs in 1990–1991 increased by half to US\$5.7 billion.¹⁰ The government had to bear the additional burden of airlifting and rehabilitating 112,000 Indian workers from the Middle East as remittances from the region declined.¹¹ The second shock was global recession: world growth had declined from 4.5 percent in 1988 to 2.25 percent in 1991.¹² Export growth in the United States—India's largest market—turned negative in 1991. Conditions in the Soviet Union, another major export destination, had also worsened. In 1990–1991 India's exports grew only 4 percent.

India was also suffering from internal political instability. The fragile National Front coalition faced a nationwide crisis in the summer of 1990 over its affirmative action policies. By autumn, a campaign by the BJP (an upper caste-dominated coalition partner) to build a Hindu temple at the site of a sixteenth-century mosque in Ayodhya resulted in widespread communal violence. The government collapsed when the BJP pulled out. A new minority government failed to pass the scheduled budget in February 1991 when it lost the Congress Party's external support. In May 1991, while

campaigning for the general elections, former prime minister Rajiv Gandhi was assassinated.

In reaction, and in parallel to these developments, the economic situation worsened. By September 1990, net inflows of Non-Resident Indian deposits had turned negative. Access to commercial borrowing had become more costly, and by December even short-term credit was restricted. Foreign exchange reserves fell to \$1.2 billion in January 1991. By the time a new government took over in June, reserves could cover only two weeks of imports. India was close to defaulting on its sovereign debt for the first time in its history.¹³

The 1997 Crisis

In 1997, India was much less vulnerable, both relative to 1991 and to most East Asian economies.¹⁴ The fiscal deficit, although still high, had declined since the early 1990s. The current account deficit had fallen to 1.25 percent of GDP in 1996–1997. External debt as a proportion of GDP (24.7 in 1996–1997) was a fraction of that of Indonesia (61.3) or Thailand (62). The debt service ratio had fallen fourteen percentage points since 1990 to 21.2 percent in 1996–1997. The predominantly state-owned banking sector had nonperforming loans that were only 8 percent of total loans. And while many countries were exposed to a common creditor country, this was not the case with India.

The better fundamentals influenced expectations of crisis. In 1996, the IMF calculated that East Asian countries had balance-of-payments (BOP) crisis probabilities ranging from 25 percent for the Philippines to 65 percent for Thailand. India's probability was just 11 percent.¹⁵

But as in 1990–1991, India was again experiencing political instability. A minority coalition government twice lost parliamentary support of the Congress Party during 1996–1998. In May 1998, the two-month-old BJP-led government engineered nuclear tests, inviting widespread sanctions. Fresh commitments from the World Bank, Asian Development Bank, and bilateral donors ceased. Credit rating agencies downgraded India, and foreign institutional investors withdrew funds.

Against this background, India faced the East Asian crisis, which spread as far afield as Russia and Brazil. Speculative pressures on India persisted from August 1997 to February 1998. The pressure increased in May 1998, when the United States imposed economic sanctions on India for detonating five underground nuclear explosions. The foreign exchange market was particularly volatile. Yet, India emerged relatively unscathed.

The pressures of 1991 and 1997 were managed against a backdrop of international and domestic constraints faced by policymakers. Many in India

viewed foreign investment and international financial institutions with great suspicion. A highly regulated economy was considered necessary to keep control over limited economic resources. The experiences of dealing with the IMF and World Bank in the 1960s and 1980s had reinforced the sense that India should be self-reliant. Moreover, in a parliamentary system, executive authority was greatly constrained for minority governments. Powerful interest groups opposed to liberalization—a vast bureaucracy, labor unions representing 20 million public sector employees—not only affected the wage bill but also had immense political clout.¹⁶ These constraints variously shaped the scope and speed of policy changes, as can be seen by examining four key decisions: devaluation in 1991; the IMF program of 1991–1993; partial internal financial liberalization from 1994 onward; and the gradualist change in the exchange rate and external sector.

Devaluation, 1991

In summer 1991, with dwindling foreign exchange reserves, India considered four options. There was a strong temptation to default, but the action would have certainly been self-fulfilling. Since December 1990, India had been borrowing on a daily basis, so market confidence was already eroded; a default would have destroyed any remaining credibility. Policymakers had no intention of souring India's record of repaying debts on time. The second option—seeking private funds—was also unrealistic: Non-Resident Indians withdrew \$1.3 billion during April–September 1991. A third strategy was to pawn gold. In April, the then caretaker government had raised \$200 million from the Union Bank of Switzerland through a sale of 20 tonnes of gold. In July, another 47 tonnes were shipped to the Bank of England to raise \$405 million. The measure had the merit of signaling India's credibility.¹⁷ But India's problem was not temporary; it had to shift away from recurring liquidity squeezes. More unpopular measures were necessary.

The new prime minister, Narasimha Rao, appointed an Oxford-educated former academic/bureaucrat, Manmohan Singh, as finance minister. Singh had served in all major economic positions in the country, including as governor of India's central bank, the Reserve Bank of India. As secretary-general of the South Commission, he had also had close interactions with IMF managing director Michel Camdessus. As economic adviser to the previous prime minister, Singh was not new to the impending crisis. To him, making exchange rate adjustments, implementing fiscal reform, and influencing business expectations were the most immediate policy priorities.¹⁸ If the objective was to send signals to the markets, Singh's appointment was a clever move.

Devaluation had become necessary. Some cabinet members and even the president opposed the move before the new government had sought a vote of confidence.¹⁹ Rather than seek cabinet approval, Singh instructed the Reserve Bank of India (RBI) to announce new intervention rates, signaling the willingness to let the rupee fall further. The devaluation occurred in steps. On 1 July, Singh tested the waters before effecting any large change in the value of the rupee. When the markets reacted positively, a second devaluation occurred, on 3 July. Overall, the RBI depreciated 17.38 percent against the pound.²⁰ That a minority government could devalue the rupee was itself a signal of credibility.

The crisis brought internal liberalization onto the agenda, which some technocrats, entrepreneurs, and Non-Resident Indians had been pushing for.²¹ Leading the demands was a new team of technocrats. Singh established close coordination between the prime minister's office, the finance and commerce ministries, and the RBI. By late 1991, Arvind Virmani was appointed economic adviser²² and Montek Ahluwalia (formerly of the World Bank) became secretary of the Department of Economic Affairs.²³ Ashok Desai, another Oxford-trained academic, became chief consultant, and Raja Chelliah (a public finance expert) was appointed minister of state. In 1992, another advocate of reforms, C. Rangarajan, was appointed RBI governor. In 1993, Shankar Acharya was called in from the World Bank as chief economic adviser. Technocrats were beginning to dominate the upper echelons of the bureaucracy.²⁴ The opportunity now existed for the IMF/World Bank to interact with "like-minded" policymakers at the highest levels of decisionmaking.

IMF Program, 1991–1993

If devaluation worked, why was the IMF approached at the same time? In financial terms, the IMF's assistance was relatively minor—in 1991–1992 it amounted to \$1.2 billion. Set against India's short-term debt of \$6 billion and daily needs of \$2 billion to rollover debt, the IMF was clearly not the most significant lender. India's decision to seek an IMF program requires an explanation.

Two earlier episodes of seeking IMF loans had been mixed experiences. In 1966 (at the peak of the Cold War), the United States had unsuccessfully applied pressure on India to liberalize trade. India had agreed to a World Bank–IMF devaluation and reform package. But the program was soon abandoned due to widespread political opposition.²⁵ In 1981, thanks to oil price hikes, India sought an IMF loan that would be the largest to a developing country up to that point. Despite US opposition, India's strategy

to approach the IMF *before* a crisis hit and its promises of economic reforms won over other executive directors. India halted the program midway, but its “home-grown conditionality” showed that a poor country could engage effectively with the IMF.²⁶ This was to be crucial for the 1991 episode.

Interviews with senior finance ministry officials revealed that informal proposals had been put to the IMF as early as September 1989. Despite ideological opposition, the impending crisis did not go unnoticed. Finance Minister Madhu Dandavate declared in his budget speech in February 1990 that “the fiscal imbalance [was] the root cause of the twin problems of inflation and the difficult [BOP] position.”²⁷ A year later, another finance minister, Yashwant Sinha, admitted that by November 1990 the economic situation had attained “crisis proportions.”²⁸ Between July and September 1990, India drew \$660 million from its reserve tranche in the IMF. By the end of 1990, when reserves could cover only three weeks of imports, India negotiated \$1.8 billion under the Compensatory and Contingency Financing Facility (CCFF) and the first tranche of a standby arrangement. The CCFF, an emergency measure, imposed little conditionality, but the government took harsh steps to suppress imports.

The technocrats now believed that medium-term structural adjustment had to accompany emergency stabilization. The Congress-led government that took power in June 1991 introduced widespread policy changes: abolition of industrial and import licensing; removal of investment caps on large conglomerates; removal of public sector exclusivity in all but six industries; access to foreign technology; and cuts in import duties. Economic policy had to undergo “a transition from a regime of quantitative restrictions to a price-based mechanism [and less] bureaucratisation.”²⁹ What differentiated India was its desire to approach these changes gradually.

The IMF was approached to underwrite the reforms. Under the CCFF agreement, India had already withdrawn \$221 million in July 1991 and \$637 million in September 1991. Since stabilization measures would take time to rebuild reserves, the RBI estimated \$3 billion was needed to “undertake reforms without undue disruption.”³⁰ India’s Letter of Intent of August 1991 outlined its own proposals for policy reform. By November, a standby arrangements promised \$2.3 billion over twenty months. There was also an expectation of concessionary loans under the Enhanced Structural Adjustment Facility. And the Aid India Consortium pledged \$6.7 billion, with another \$7.2 billion for 1992–1993.

Compared to previous episodes, India’s relation with the IMF in 1991 was vastly different. First, the groundwork for reforms had already been laid since late 1990. The previous finance secretary, S. P. Shukla, and the chief economic adviser, Deepak Nayyar, had prepared the February 1991 budget, but political instability had stalled further progress. There were

differences of opinion on the scope of stabilization measures but, at the very least, the need for reform was acknowledged. Second, senior policymakers who had experience in the World Bank and the IMF could now rely on their old networks to secure support for India. Third, the relationship was now more technocratic and less political. With the Cold War over, unlike in 1966 and 1981, the crisis was not one of strategic interest for the G7 countries.³¹

The World Bank also stepped in to support the new policies. In December 1991, it approved a structural adjustment loan of \$500 million. Another \$900 million was raised to support social safety net programs, and in June 1993, it gave \$300 million to support external sector liberalization. Beyond financial support, there were also extensive consultations between the government and the Bank. For critics this was external pressure, while others saw it as “leaning against doors.” But the engagement deepened; in 1997, the Bank engaged in policy discussions with individual states, with state-level adjustment lending becoming an important part of the portfolio.³²

Domestic constraints were partially overcome. Opposition parties accused the government of surrendering India’s sovereignty, while Singh insisted that India was bound only by the conditionalities it had proposed.³³ Parliament did not have to ratify agreements with the IMF, but it could stall budgets for a minority government. Eventually, the budgets of 1991, 1992, and 1993, which had the core elements of economic reform, did pass. The reason lay partly in India’s shifting political cleavages. The leftist, regional, and lower caste-dominated parties (which traditionally formed the opposition) did not want to ally with a communally divisive BJP to bring down the Congress Party government: they “disliked the reforms, but *they disliked Hindu nationalism even more.*”³⁴ Critics also argue that the leadership of none of the major parties was willing to oppose the IMF’s policies.

Other sources of support for the new policies emerged. In 1992, a new lobby, the Confederation of Indian Industry, gained in prominence by articulating the interests of a growing breed of export-oriented firms. India’s growing middle class also greeted the consumer goods boom in the late 1980s, spurred by a hike in central government employees’ salaries. But even these new interests were not keen on letting go of the subsidies they enjoyed. Singh tried to placate labor unions by promising a National Renewal Fund to compensate and retrain laid-off workers.³⁵ But opposition remained strong.

Ultimately, fiscal pressures ensured that the IMF relationship did not last long. There was no extension of the IMF standby arrangement beyond 1993 (see Table 1). Reserves had climbed to \$9.83 billion by the end of 1992–1993, and economic growth had recovered to 4 percent. It was a “sign of strength” for India to not be dependent on external support.³⁶ But all former officials interviewed admitted that the IMF’s demands on fiscal prudence were more than India could deliver. Special interests demanded subsidies,

Table 1 India: History of Lending Arrangements, 1 May 1984–31 May 2006 (in thousands of SDRs^a)

Facility	Date of Arrangement	Date of Expiration or Cancellation	Amount Agreed	Amount Drawn	Amount Outstanding
Standby arrangement	31 Oct. 1991	30 June 1993	1,656,000	1,656,000	0
Standby arrangement	18 Jan. 1991	17 Apr. 1991	551,925	551,925	0
Extended Fund Facility	9 Nov. 1981	1 May 1984	5,000,000	3,900,000	0
Total			7,207,925	6,107,925	0

Source: International Monetary Fund, "India: History of Lending Arrangements from May 1, 1984 to May 31, 2006," at www.imf.org/external/np/tre/tad/extarr2.cfm?memberKey1=430&date1key=2006%2D05%2D31.

Note: a. Special drawing rights is a unit of account in the IMF, whose value is based on a basket of key international currencies. As at 18 August 2006, 1 SDR was worth \$1.48672.

India's public was inflation-sensitive, and the economy had structural rigidities that increased the cost of adjustment. Food and fertilizer subsidies, targeted at poor households and farmers, rose 72 percent during 1991–1997. Their share of explicit central government subsidies increased from one-half to nine-tenths during 1990–1996.³⁷ Government salaries increased and state governments continued with populist policies. After briefly dipping, the fiscal deficit continued worsening. Another IMF program would threaten subsidies, employment, and social expenditures. Technocratic decisions were easier to enforce, but a continuation of an IMF program was politically infeasible.

Partial Internal Financial Liberalization

A further Indian response to the pressures of the 1990s was to initiate institutional reforms and liberalize the financial sector. Statutory independence for the Reserve Bank of India (to stop the practice of monetizing deficits) was examined but rejected because the Indian economy faced high structural rigidities.³⁸ That said, some important institutional changes occurred. In 1994, the government started phasing out the use of ad hoc treasury bills. It was hoped that having to borrow in the market would force governments to become more prudent. But to ease short-term liquidity problems, the RBI raised the limits on the "ways and means advances" to state governments. The RBI also gained some autonomy: the exchange rate was no longer controlled by the finance ministry.

In parallel there were modest reforms in the banking system. These included removal of interest rate ceilings and credit authorization requirements; reduction of cash reserve ratios and statutory liquidity requirements;

dilution of 100 percent government ownership; establishment of a Debt Recovery Tribunal; and adoption of Basel I prudential norms to fix capital-to-risk assets ratio and disclosure requirements.³⁹ The new accounting norms exposed the weakness of the system. Of the twenty-eight public sector banks, twenty-six declared net profits in 1991–1992; only fifteen did so in 1992–1993.⁴⁰ But the banking sector remained largely under government control. The objectives of priority lending and protection of depositors' interests remained dominant, while labor opposition by some 880,000 public sector bank employees prevented further change. Technocratic decisions were easy to enforce, but entrenched interests were harder to displace.

Capital market reforms were more noteworthy. The Securities and Exchange Board of India (SEBI) was established as an independent regulator by a presidential ordinance in January 1992 (followed by the SEBI Act).⁴¹ In November 1992, the National Stock Exchange (NSE) was incorporated. Using electronic trading it became the most liquid exchange in the country within a year and reduced the risk of fraud. Several stock market scams in the 1990s, driven by manipulative yet entrenched brokers in the monopolistic Bombay Stock Exchange, affected smaller investors. The NSE's shareholders, by contrast, were large banks and mutual funds representing millions of households. The NSE's advent shifted the political economy of the securities markets.⁴²

Both banking sector and capital market reforms set in motion institutional changes that were necessary for reducing external vulnerability. Compared to East Asian countries, India's financial sector was a source of market confidence.

Gradual Changes in the External Sector

India's response to the Asian crisis also involved exchange rate policy and a new approach to the external financial sector. Until 1991, the rupee was pegged to an undisclosed basket of currencies. After India devalued the rupee in July, it had three options: continuation of an administered peg at the new rate; immediate transition to a market-determined exchange rate; or phased liberalization of the regime.

An administered peg was no longer feasible. The rupee had failed to depreciate fast enough in the late 1980s, which was one of the reasons behind the high current account deficit and sluggish exports. In the aftermath of the crisis, persisting with an administered rate would have further undermined market confidence.

There were clear advantages in having a market-determined rate: competitive exports; elimination of the foreign exchange black market; and the ability of the RBI to focus on monetary policy to control inflation. But

there was the downside to speculative fluctuations. Another crisis would have undermined nascent reform efforts. Also, market-determined rates would have meant that defense and administrative imports and debt service would impose a greater fiscal burden. It was preferable to pay for these with foreign exchange surrendered at the lower official rate.⁴³ The RBI's objectives stemmed from these considerations: reduce exchange rate volatility; maintain adequate reserves; and create a market for foreign exchange.⁴⁴

India opted for phased liberalization. In March 1992, a dual exchange rate regime—the liberalized exchange rate management system (LERMS)—was introduced. The scheme, which was to run for two years, taxed exporters in order to subsidize government-related imports. But, by February 1993, with rising reserves, India adopted a unified, market-determined exchange rate.

One major lesson from the 1991 crisis was the danger of excessive debt. The government took early steps to rectify the situation. A new institution, the External Debt Management Unit, would work to reduce short-term debt and encourage non-debt-creating flows. Not only did the total debt stock decline, but short-term debt as a proportion of foreign exchange reserves fell dramatically: from 382 percent in 1990–1991 to 19 percent in 1997–1998.

Another lesson learned was the need to rebuild foreign exchange reserves. Reserves had to be adequate (to cover short-term debt and the current account deficit); liquid (for use in emergencies); and transparently built.⁴⁵ India took preventive steps to maintain liquidity by issuing bonds to Non-Resident Indians: the Resurgent India Bonds in August 1998 (in response to the 1998 nuclear sanctions) raised \$4.2 billion, and the India Millennium Bonds in October 2000 yielded \$5.5 billion. The RBI also published foreign currency transactions on a monthly basis, thus conforming to the IMF's Special Data Dissemination Standard.

In 1991, to build reserves, the foreign direct investment (FDI) regime was liberalized.⁴⁶ In September 1992, foreign institutional investors could invest in the secondary market and, soon after, in the primary market as well. In fact, India was one of the first emerging economies to open its equity market to portfolio investments. During 1996–1997, foreign institutional investors could also invest in government securities. By increasing investment and publicizing market opportunities in India, equity capital, it was believed, would develop the domestic equity market and attract more stable FDI.

Another example of phased liberalization was current account convertibility, introduced in August 1994. The decision was taken in response to the recommendations of the High-Level Committee on Balance of Payments 1993 (chaired by RBI governor Rangarajan).⁴⁷ But the committee also cautioned against “capital flight through liberalized windows of transactions.” So, indicative limits were placed on the value of different types of current

transactions. To avoid the “dollarization” of the currency, akin to many Latin American economies, offshore rupee transactions and dollar-denominated transactions between residents were prohibited.⁴⁸

More important, the RBI gained experience in handling volatility. Between September 1993 and October 1994, India experienced a surge in capital inflows of \$12.2 billion.⁴⁹ Policymakers, uncertain about its permanency, were hesitant to allow a nominal appreciation that could undermine export competitiveness.⁵⁰ They considered relaxing trade restrictions (so that inflows could finance additional imports), but this was politically difficult. Lowering barriers to capital outflows was risky, while raising them against inflows militated against the objective of building reserves. The RBI went in for partial sterilization by increasing reserve requirements and selling government securities, thus avoiding any adverse impact on exports. It sent a signal to the markets that it was unwilling to allow irrational volatility in the exchange rate.⁵¹ The experience was to prove crucial during the Asian crisis.

Moreover, IMF advice was politely ignored. It had advised against sterilization but its India Staff Division later endorsed the strategy.⁵² It also urged the government to remove exchange restrictions under Article VIII of the IMF’s Articles of Agreement “as quickly as possible.”⁵³ But outside of a formal arrangement it had limited influence.

In June 1997, the Tarapore Committee on Capital Account Liberalisation made a path-breaking recommendation. It proposed a three-year phase plan for introducing capital account convertibility (CAC), subject to pre-conditions such as a lower fiscal deficit, a targeted inflation rate, and fewer nonperforming assets.⁵⁴ The rationale: exchange reserves were rising and with the services sector growing in importance, it was increasingly difficult to distinguish current from capital transactions.⁵⁵

Although CAC did not need parliamentary approval, this was not entirely a technocratic decision—private interests were also in favor. Three groups had emerged since 1991 with an interest in convertibility. First, foreign institutional investors wanted the freedom to both invest and withdraw funds at will. Second, Non-Resident Indians seeking to invest at “home” without limits on outflows wanted appropriate incentives.⁵⁶ Third, an emerging constituency of companies and individuals that had enjoyed a six-fold increase in stock market capitalization during 1990–1997 wanted freer capital flows.⁵⁷

But the Asian crisis exposed the dangers. Similar to its earlier experience, the RBI strongly intervened in the market: outstanding forward sales of foreign currencies increased from negligible levels in August 1997 to \$3 billion in January 1998.⁵⁸ In November 1997, the RBI also followed a tight money policy to control inflation. Even so, the rupee depreciated 16.7 percent between the end of September 1997 and the end of June 1998.⁵⁹

Yet, the impact was not severe. GDP growth dipped to 4.8 percent in 1997–1998 but rose again to a healthy 6.5 percent in 1998–1999. By December 1998, reserves had reached \$27 billion, and by the end of 1999, they were higher than in the precrisis period, standing at \$35 billion with a six-month import cover. Even the current account deficit fell to just 1 percent of GDP in 1998–1999. The crisis was fortuitous occurrence: had it occurred a few years later, the proposed CAC regime might very well have left India exposed.

Thanks to the crisis, though, capital outflows were only gradually liberalized.⁶⁰ In September 1992, Indian firms could raise funds in international markets, but international commercial borrowing was highly regulated. Banks were not allowed, until very recently, to accept deposits or extend loans denominated in foreign currency, except for Non-Resident Indians' deposits and exporters' accounts. Although the Tarapore Committee recommended that flows on individual accounts be liberalized first, outflows were made easier for firms and financial intermediaries.⁶¹ Indian firms could invest abroad for business expansion but were not allowed to hold foreign financial assets. Foreign institutional investors could repatriate the principal, interest, and capital gains, but short-term capital gains were taxed at a higher rate than for domestic investors. The objective was clear: the government wanted to attract foreign investment from specific sources but restrict capital transactions for other entities. Capital controls prevented excessive dependence on foreign credit, regulated capital flight, and minimized exposure to regional foreign exchange risk.

Consequences and Conclusions

India's experience was different from that of other countries. The banking system did not have overseas liabilities, nor did private entities owe large sums to international creditors. Foreign institutional investors did not lose money on their investments. The country did not default, and two crises were averted.

The consequences of the pressures in the 1990s on growth and poverty in India were more complex. Relative to the 1980s, average incomes grew faster during 1990–2003—4 percent annually. In the immediate aftermath of the 1991 crisis, critics pointed to rising poverty incidence.⁶² And the poor suffered from double-digit inflation during 1991–1996 due to a combination of factors: import constraints, weak agricultural growth, cuts in subsidies, and inadequate monetary sterilization. But, overall, poverty fell from about 37 percent in 1990 to about 26 percent in 1999–2000, though adjusted estimates show the decline was more evenly spread since 1987.⁶³ However, the rural-urban poverty gap increased, thanks in part to sluggish agricultural

growth of only 3.2 percent during 1993–2000. Furthermore, the dynamism in the services and manufacturing sectors was concentrated in the south and the west, whereas jobless growth meant that poverty rates continued to exceed 60 percent in parts of Bihar, Orissa, Madhya Pradesh, and Uttar Pradesh.⁶⁴

The crises also affected social sector spending and outcomes. Although allocations rose in absolute terms, the rate of increase slowed until 1997 before picking up again.⁶⁵ Central and state spending as a percentage of aggregate public expenditure declined slightly in the first half of the 1990s but rose after 1994–1995. The inability to substantially widen the tax base and narrow the black economy meant that public funds for social sectors remained constrained. As a percentage of GDP, social expenditure did not increase in the 1990s.⁶⁶ The impact was that relative to the 1980s, the rate of reduction in child mortality (a key indicator of improving human development) was lower in the 1990s, exactly when income growth was surging.⁶⁷ In 2005, Singh, who had by then become prime minister, launched the National Rural Health Mission, admitting that “we . . . paid inadequate attention to public health.”⁶⁸

Several lessons—and questions—emerge from India’s experience, the most important of which is ownership of policy. Despite criticisms of external pressure, the government’s unilateral announcement of economic reforms was its strongest defense. Given India’s precarious situation in 1990–1991, negotiating a loan would have been much harder without broader reforms in the pipeline. But ownership allowed India to set its own pace of reform. Outside of an immediate crisis, the IMF has less bargaining power vis-à-vis the government. Indian policymakers decided not to continue with the standby arrangement because they could not meet stronger conditionality. Does ownership hinder broader reforms? Perhaps, but the fact that India could design reforms suited to its conditions suggests that gradualism as a sign of “national strength” should not be underemphasized.

A related question is about the nature of IMF involvement. Potentially, it could provide *cash* (as lender of last resort), help increase the technical *capacity* of policymakers, and even help *coordinate* the efforts of various ministries. India relied on IMF funds, and its policymakers benefited from close interactions with IMF and Bank staff, which also added *credibility*. Both crises created the conditions for reform, but the government took charge, introducing emergency measures in 1991, while maintaining capital controls in 1997–1998. The government also coordinated policy by establishing a close working relationship between different departments. Policy papers advocating reforms had been in circulation for some years. While engagement with the IMF opened the space for reform, it did not impose alien ideas, nor was IMF advice always heeded.

A third question is whether policymaking by technocrats increases the probability of success. The Indian experience shows that decisions of a

more technical nature, like devaluation or the exchange rate regime, could be taken without much parliamentary consultation. Others, like external liberalization or capital market reforms, were in response to new interests that were developing within the economy. But issues like subsidies, privatization, and social spending adversely affected older interests—rich and poor farmers, public sector employees, lower tiers of the bureaucracy, and others. Democratic opposition helped to direct policymakers' attention to inflation, poverty, and developmental outcomes. These problems were not wholly addressed, but the adverse impact of the crises and stabilization measures remained limited, relative to many other countries in this special issue. Many policy measures were criticized in the 1990s, but reforms were never discredited: every government in the 1990s nudged policies forward.

Finally, a bigger question is whether structural reforms can really be separated from emergency stabilization measures. Structural reforms in India—privatization, industrial policy, and trade policy—involved several competing interests, which have not been discussed in this article. But these issues have been the more contentious for India's political economy. In some ways, the absence of rapid privatization, excessive short-term borrowing by banks, or liberalized capital flows served India well when financial contagion was sweeping its neighboring regions. At the same time, several minority governments survived, and technocrats ensured continuity of policies across administrations. A democratic, gradualist path to structural reforms increased India's immunity. As India integrates more closely with the global economy (reserves are now over \$150 billion), further policy changes might be in the offing—and they will continue to test the balance of institutional and political power of new and old interests. 🌐

Notes

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1. With the tax base not expanding, indirect taxes accounted for 85 percent of total revenue.

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