Chapter 1

*Introduction*
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1.1 The Problem

During the past two decades, India has experienced wide ranging reforms in the various sectors of the economy. These reforms were initiated in July 1991 when an economic crisis of unprecedented severity surfaced in the country in the form of high inflation, rising food prices, large current account deficit, huge domestic and foreign debt, a sharp fall in foreign exchange reserves, a steep decline in India's credit rating, and a cut off of commercial loans accompanied by a net outflow of Non-Resident Indian (NRI) deposits.

In that year the consolidated gross fiscal deficit of the central and state governments had reached the level of 9.4% of GDP, the current account deficit 3.1% of GDP and trade deficit 3.2% GDP. The inflation rate was more than 10% and by the summers of 1991, foreign exchange reserves were below two weeks worth of imports. GDP growth rate was 1.3% in the crisis year 1991-1992. The debt servicing payments amounted to as much as 35.3% of current foreign exchange receipts. Short term debts amounted to a dangerously high level of 146.5% of foreign exchange reserves by the end of March 1991. The internal debt increased from 35% of GDP in 1980-1981 to 53% of GDP in 1990-1991. India's external debt was $83.8 billion and the debt service payment was about 30 per cent of exports of goods and services in 1990-91. The affect was directly on foreign exchange reserves which decline to $1.1 billion (Srinivasan and Tendulkar, 2003).

Table 1.1 summarizes the state of the Indian economy in 1990-91.
Table 1.1

State of Indian Economy in 1990-1991

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross fiscal deficit</td>
<td>9.4% of GDP</td>
</tr>
<tr>
<td>Current account deficit</td>
<td>3.1% of GDP</td>
</tr>
<tr>
<td>Trade deficit</td>
<td>3.2% of GDP</td>
</tr>
<tr>
<td>Inflation</td>
<td>More than 10.0%</td>
</tr>
<tr>
<td>Foreign exchanges reserve</td>
<td>Below 2 weeks worth of imports</td>
</tr>
<tr>
<td>GDP growth rate</td>
<td>1.3%*</td>
</tr>
<tr>
<td>Debt servicing payment</td>
<td>35.3% of current foreign exchange receipts</td>
</tr>
<tr>
<td>Short term debt</td>
<td>146.5% of foreign exchange reserves**</td>
</tr>
<tr>
<td>Internal debt</td>
<td>53.0%</td>
</tr>
<tr>
<td>Debt service payment</td>
<td>30% of goods and services</td>
</tr>
</tbody>
</table>

*1991-1992

** By end of March 1991.

Source: Based on Srinivasan and Tendulkar, 2003

Thus, all crucial indicators of India’s economy were running in danger zone in 1990-1991. This was not sustainable for the progress of Indian economy and its impact was reflected on the growth rate of Indian economy which was 1.3% only.

This economic crisis was the outcome of the long-term constraints of the preceding four decades, especially the 1980s and certain immediate factors. Upon achieving independence from British rule in 1947, India pursued policies that sought to assert government planning, in most sectors of the economy and promote self-sufficiency.

Economic nationalism was essentially a reaction to the colonial regime’s laissez faire and free trade policy that was identified as the basic cause of India’s economic underdevelopment by the pre-independence political leadership (Srinivasan, 1996; Srinivasan & Tendulkar, 2003; Tendulkar & Bhavani, 2005, 2007). These policies achieved some economic goals (such as rapid industrialisation) but the overall effect
was to promote widespread inefficiency throughout the economy. The strategy of import substituting industrialisation made the Indian industry inefficient and technologically backward due to the absence of competition. Discouragement of foreign capital compounded this problem. Private sector was heavily regulated through the system of licenses and permits. This caused a great damage to entrepreneurship and innovation. Public sector dominated this strategy but become highly inefficient and even sick due to the excessive political interference. Emphasis on self sufficiency led to export pessimism. Imports, on the other hand, could not be contained as they consisted of essential goods and key inputs which were very much needed for accelerating the pace of industrialisation. As a result, imports ran ahead of exports and the country experienced a continuous trade deficit with the exception of two years 1972-73 and 1976-77 when there were some surpluses on this account. The fiscal situation deteriorated through the 1980s due to the populist policies pursued by the government, rapid growth of state controls over the economy and reservation of certain areas for small scale industries.

The import liberalization of the late 1980’s was not tied to a larger export effort, its main immediate thrusts was towards producing more goods, luxury goods for the domestic market. In 1985-86, the very first year that the policy was introduced, there was a dramatic increase in balance of payments deficits, with the current account deficit increasing to 2.26% of GDP.

However, the immediate factors which triggered this crisis were the Gulf war of 1990, and the collapse of the Eastern Block. The Gulf war led to the surge in India’s oil import bill and cessation of exports to Iraq due to UN trade embargo on that country. Repatriation of workers from Kuwait ceased their remittances and led to foreign exchange expenditure on transporting Indians from the affected countries in the Middle
East. The collapse of Eastern block – India's major trading partner at that time – further aggravated the balance of payments crisis.

The export growth slowed down to 9.2% (in U.S. dollar terms) in 1990-91 (from 18.9% in 1989-90) as a result of breakdown of bilateral trade with the U.S.S.R. and a slowdown in the OECD countries (Tendulkar and Bhavani, 2005). The trade deficit broke all previous records amounting to $9438 million in FY 1990-91 (Sharan and Mukherjee, 2001). India's share in world trade declined to 0.53% by 1991 from 1.8% in 1950 (Bhasin, 2005). Statistics (GOI, 1993; GOI, 1994; Sharan and Mukherjee, 2001) shows that India’s external indebtedness was increasing. The magnitude of external debt moved up from $23.5 billion in 1980-81 to $83.96 by March 1991. Its share in GDP went up from 13.7% to 41.1% during corresponding period. The structural change in capital account transactions during the 1980s was also manifested in the form of growing foreign direct investment, for which the policy of the Indian Government was found encouraging. The amount of foreign investment inflow was significant, yet in view of the exorbitantly large current account deficit, the inflow did not reach even the half way mark. The natural victim was the foreign exchange reserves that were ultimately not capable of meeting even two and a half month's imports bill (Sharan and Mukherjee, 2001).

The government tried to overcome this crisis by borrowing from the IMF but did not succeed. The country's foreign exchange assets dipped from US $3.4 billion at the end of March 1990 to a low of US $975 million on July 12, 1991. This was equivalent to barely a week's imports. The country was on the brink of default in the discharge of its international debt obligations.
In view of Bhagwati (1998), "India's democratic success has made her the unique example for the theorists of democracy today to understand, her economics has been a disappointment. To put it plainly it has been a disaster. More than a generation has been lost to policies that produced low growth rates, leaving the economy in a state of technological backwardness, low per capita income, high illiteracy and massive poverty".

The economic crisis led India to introduce reform in economic policies. The decision was also influenced by the experiences of spectacular growth of East Asian Economies of South Korea, Taiwan, Singapore and Hong Kong in 70s and 80s following the introduction of economic reforms in 1950s and 1960s and also that of China which introduced reforms in 1978. The reforms in the economic policies consisted of two basic sets of measures. The first set aimed at achieving macroeconomic stabilization by reducing both fiscal and balance of payments deficits. Reduction in fiscal deficit was sought to be achieved through cut in public expenditure and increase in public revenue. To reduce the balance of payments deficits, the reform programme heavily relied on currency devaluation to boost exports and reduce imports.

The second set of measures were directed towards altering the production structure by increasing the role of the markets in the economy directly through privatization or by way of reduction in state investments and interventions and indirectly through domestic deregulation and by trade liberalization. The structural reform measures encompassed liberalization of trade and investment policies with emphasis on exports, FDI and reduction in external debt, industrial deregulation disinvestment and public sector reforms and reform of the capital markets and the financial sector (For details see Chapter 3 of the present study).
The reforms were introduced with a view to provide a new dynamism to the economy by improving the overall productivity, competitiveness and efficiency. Over the past two decades since 1991, the reform measures have been intensified and extended in many directions.

1.2 Objective of the Study

In the above background and also in recognition of the growing importance of the external sector in Indian economy, this study has been undertaken primarily to assess the impact of economic reforms on the external sector of India.

Further as within the external sector the main focus of economic reforms has been on expansion of trade, capital inflows and reduction in external debt burden, the specific objectives set out for the study are:

(i) To provide insight into the reforms that have been introduced in India in the field of foreign trade, foreign direct investment and external debt since 1991.

(ii) To examine the impact of these reform measures on trade, foreign direct investment and the external debt.

(iii) To identify factors that constrains India’s performance in these fields.

(iv) To suggest policy measures which should be taken to improve competitiveness of exports, overall investment climate and reduce external debt burden in the long run.

1.3 Hypotheses of the Study

The study tests the following hypotheses:

1) The impact of economic reform policy package on India’s external sector has been broadly positive.
2) Reforms have improved India’s trade performance significantly in the post-reform period compared to that of pre-reform period.

3) External sector reforms have led to the acceleration in FDI inflows to India during the post-reform period.

4) India’s external debt position in the post-reform period has improved considerably following the introduction of policy reforms in managing the debt.

1.4 Database and Methodology

The study is based on the time series secondary data collected from publications of various authors as well as the publications of the government agencies. Due acknowledgement has been given to them at appropriate places.

Though the study has as its period of reference the years after 1991, but to assess the impact of economic reforms on the external sector, we have examined the performance of external sector during 1992-2010 (post-reform period) and then compared the same with performance during 1980-1991 (pre-reform period). The year 1991-1992 is excluded from the analysis due to the economic crisis of 1991 and abrupt changes in 1991-1992. The post-reform period is further sub-divided into two sub-periods covering the decade of the 90s and the first decade of the 21st century to examine the impact of reforms more intensively.

The methodology used is simple and analytical and does not go beyond calculations of percentages, arithmetical averages, year to year, and trend rates of growth. Yearly growth rates are computed as under:

\[
G_t = \frac{Y_t - Y_{t-1}}{Y_{t-1}} \times 100
\]

Where,

\[G_t\] = Growth rate for period \(t\)
\[ Y_t = \text{Value of the variable in period } t \]
\[ Y_{t-1} = \text{Value of the variable in period } t-1 \]

The trend rate of growth has been worked out by estimating the function:

\[ Y = AB^t \]

\[ \log Y_i = \log a + t \log (b) \]

Where,

\[ Y = \text{Value of Exports} / \text{Imports} \]
\[ t = \text{Time variable} \]
\[ B = \text{Growth rate or } (B-1) \times 100 \]

The significance of the growth rates has been tested by applying t-test and estimating \( R^2 \).

1.5 Plan of the Study

The study is organized in seven chapters including the present one. Chapter 2 is devoted to a brief review of existing literature in the field. Chapter 3 provides an overview of key reforms that have been introduced in the Indian economy since 1991. Chapter 4 to 6 is devoted to the appraisal of reform process in foreign trade, foreign investment and external debt respectively. Finally Chapter 7 summarizes the study, highlights the important findings and offers policy suggestions to improve external sector on a sustained basis.
Reference


Sharan, Vyuptakesh and Mukherjee, I.N. (2001), India’s External Sector Reforms, Oxford University Press, New Delhi, pp. 19, 118.

Srinivasan, T.N. and Tendulkar, Suresh D. (2003), Reintegrating India with the World Economy, Oxford University Press, New Delhi, pp. 1, 13, 27, 28, 30.

