6.1 Crisis in Balance of Payments

6.2 Causes Behind the Crisis

6.3 Policy Measures to Overcome the BOP Crisis

6.4 Summary

6.1 CRISIS IN BALANCE OF PAYMENTS

Macroeconomic crisis can be defined as “the one which generally takes the form of accelerating inflation and unsustainable fiscal and current account deficits.”¹ The deterioration in India’s balance of payments situation which started from the Seventh Plan onwards ultimately reached to a critical position in the year 1990 – 91. Thus, the year 1990 – 91 can be considered as the most difficult year from the India’s balance of payments point of view. This was considered as the fourth macroeconomic crisis. Hence, the fact that India’s balance of payments assumed the nature of a ‘crisis of an unmanageable proportion’ became well – established by the close of the eighties itself.

In fact, several economists as well as the official documents like Economic Survey, RBI’s Annual Report & Report on Currency & Finance¹ had pointed out the likelihood of balance of payments crisis. However, it was the Economic Advisory Council’s Report (1989) which admitted the severity and also gravity of balance of payments situation. In this context, Wadhwa (1990) noted – The Economic Advisory Councils’ Report (1989) categorically declared that – “By 1988 – 89, the
balance of payments was under severe pressure and significant loss of foreign exchange reserves was being experienced... It further inferred that - sources of balance of payments pressure during the year were partly from the trade account and partly from the deteriorations in the invisibles and capital account of the balance of payments.”

So, this was perhaps for the first time that any government commissioned document has admitted the severity of balance of payments pressure. Moreover, there was a consensus among the economists that the prelude to the crisis was the decade of eighties. For instance, as Virmani (2001) had observed – “The BOP crisis hit India in 1990 – 91, but it had been building for at least half a decade preceding that year. The rising fiscal deficit and gradually increasing overvaluation contributed to the rising imbalance. Inadequate exchange rate adjustment in response to the external and domestic shocks during 1990 – 91 triggered the crisis.”

The state of the economy at the time of crisis in 1991 is explained by Joshi & Little (1993) as follows – “The macroeconomic crisis that erupted in July 1991 was brought about to a head by a steep fall in foreign exchange reserves to about $ 1 billion (equal to about 2 weeks imports), a sharp downgrading of India’s credit rating and a cut off of foreign lending. But the basic underlying features of the crisis were high inflation (12 per cent and rising), large fiscal and current account deficits (approximately 10 per cent and 3 per cent respectively) and a heavy and growing burden of domestic and foreign debt.”

6.1.1 Balance of Payments Situation & Select Macroeconomic Indicators 1990 to 1992

The key components of India’s balance of payments during the period 1989 – 90 to 1991 – 92 are given in table 6.1. As is evident from table 6.1 the trade deficit increased from ₹ 1.12400 crore in 1989 –90 to ₹ 1.16900 crore in 1990 – 91. The
invisibles which were having a positive balance of ₹.1025 crore turned to negative of ₹.425 crore during the same period. As a result the current account deficit increased from ₹.11350 crore in 1989 – 90 to ₹.17350 crore in 1990 – 91.

Table 6.1: Key Components of India’s Balances of Payments 1990 to 1992

(\text{In ₹.crore})

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Merchandise</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A)Exports f.o.b</td>
<td>28229</td>
<td>33153</td>
<td>44923</td>
</tr>
<tr>
<td>B)Imports c.i.f.</td>
<td>40642</td>
<td>50086</td>
<td>51417</td>
</tr>
<tr>
<td><strong>I. Trade Balance (A - B)</strong></td>
<td>-12413</td>
<td>-16934</td>
<td>-6494</td>
</tr>
<tr>
<td><strong>II. Invisibles Net</strong></td>
<td>1026</td>
<td>-433</td>
<td>4259</td>
</tr>
<tr>
<td><strong>III. Current Account (I + II)</strong></td>
<td>-11387</td>
<td>-17367</td>
<td>-2235</td>
</tr>
<tr>
<td><strong>IV. Capital Account (A to F)</strong></td>
<td>11617</td>
<td>12895</td>
<td>9509</td>
</tr>
<tr>
<td>A)Foreign Investment net</td>
<td>683</td>
<td>184</td>
<td>340</td>
</tr>
<tr>
<td>B)External assistance, net</td>
<td>3090</td>
<td>3965</td>
<td>7395</td>
</tr>
<tr>
<td>C)Commercial Borrowings, net</td>
<td>2958</td>
<td>4034</td>
<td>3807</td>
</tr>
<tr>
<td>D)Rupee Debt service</td>
<td>--</td>
<td>-2140</td>
<td>-2785</td>
</tr>
<tr>
<td>E) NRI Deposits</td>
<td>4000</td>
<td>2756</td>
<td>1008</td>
</tr>
<tr>
<td>D) Other capital</td>
<td>886</td>
<td>4096</td>
<td>-256</td>
</tr>
<tr>
<td><strong>V. Overall Balance (III + IV)</strong></td>
<td>-230</td>
<td>-4471</td>
<td>7274</td>
</tr>
<tr>
<td><strong>VI. Monetary Movements (VII + VIII + IX)</strong></td>
<td>230</td>
<td>4471</td>
<td>-7274</td>
</tr>
<tr>
<td>VII. Reserves (increase - / decrease +)</td>
<td>1230</td>
<td>2293</td>
<td>-9351</td>
</tr>
<tr>
<td>VIII. IMF net</td>
<td>-1460</td>
<td>2178</td>
<td>2077</td>
</tr>
<tr>
<td>IX. SDR Allocation</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: Reserve Bank of India – *Handbook of Statistics on Indian Economy, 2005 – 06*

Table 6.2 gives the data of select macroeconomic indicators from 1989 – 90 to 1991 – 92. It is clear from table 6.2 that the CAD/GDP ratio increased from 2.3 in 1989 - 90 to 3.1 per cent in 1990 – 91, which was clearly unsustainable. Besides this, the fiscal deficit to GDP ratio was more than seven per cent during the two years 1989 – 90, and 1990 – 91. The foreign exchange reserves were just sufficient to cover two to two and half months of imports during the two years i.e. 1989 -90 and 1990 – 91.
The average rate of inflation was 7.5 per cent in 1989 – 90, which went up to 10 per cent in the year 1990 – 91. Further in 1991 – 92, it crossed the figure of 13 per cent. The GDP growth rate which was 6.5 per cent in 1989 – 90, went down to 5.5 per cent in 1990 – 91. In 1991 – 92, the GDP growth rate was drastically reduced to 1.2 per cent. The balance of payments crisis also affected the performance of industrial sector. For example, the average industrial growth rate was 8.0 per cent in the second half of 1980s. In 1989- 90, it was 8.6 per cent and in 1990 – 91 it was 8.2 per cent. But, in 1991 – 92 there was sharp decline in industrial growth rate and it was just 0.5 per cent. The debt indicators like debt stock to GDP ratio and debt service ratio were also quite high during the said period. For instance, debt stock to GDP ratio was 28.5 in 1990 -91 and it further went up to 38.5 in 1991 – 92. The debt service ratio was 35.0 in 1990 – 91, and it was reduced to 30.0 in 1991 – 92.

**Table 6.2: Select Macroeconomic Indicators 1990 to 1992**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Current Account Deficit (As Per cent of GDP)</td>
<td>2.3</td>
<td>3.1</td>
<td>0.3</td>
</tr>
<tr>
<td>2</td>
<td>Fiscal Deficit (As Per cent of GDP)</td>
<td>7.33</td>
<td>7.85</td>
<td>5.56</td>
</tr>
<tr>
<td>3</td>
<td>Import Cover (In months)</td>
<td>1.9</td>
<td>2.5</td>
<td>5.3</td>
</tr>
<tr>
<td>4</td>
<td>Short term debt (As Per cent of total debt)</td>
<td>9.9</td>
<td>10.3</td>
<td>8.2</td>
</tr>
<tr>
<td>5</td>
<td>Debt – stock to GDP ratio (In Per cent)</td>
<td>---</td>
<td>28.7</td>
<td>38.7</td>
</tr>
<tr>
<td>6</td>
<td>Debt – Service Ratio (In Per cent)</td>
<td>---</td>
<td>35.3</td>
<td>30.2</td>
</tr>
<tr>
<td>7</td>
<td>Inflation (Annual Average) (In Per cent)</td>
<td>7.45</td>
<td>10.25</td>
<td>13.75</td>
</tr>
<tr>
<td>8</td>
<td>GDP Growth Rate (In Per cent)</td>
<td>6.7</td>
<td>5.6</td>
<td>1.3</td>
</tr>
<tr>
<td>9</td>
<td>Industrial Growth rate (In Per cent)</td>
<td>8.6</td>
<td>8.2</td>
<td>0.6</td>
</tr>
</tbody>
</table>

Source: Reserve Bank of India – *Handbook of Statistics on Indian Economy, 2005 – 06*
The level of foreign exchange reserves (excluding Gold & SDRs) for select months between December 1989 to December 1991 is indicated in table 6.3. As is evident from table 6.3, India’s foreign exchange reserves stood at ₹.5277 crore on 31st December 1989, which declined to ₹.2152 crore by the end of December 1990. Between May and July 1991 they ranged between ₹.2500 crore to 3300 crore. However, by the end of December 1991, there was a substantial increase in the foreign exchange reserves and they stood at ₹.9287 crore.

Table 6.3 India’s Foreign Exchange Reserves

<table>
<thead>
<tr>
<th>Month / Year</th>
<th>Foreign Exchange Reserves ( In ₹.Crore)</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 1989</td>
<td>5277</td>
</tr>
<tr>
<td>December 1990</td>
<td>2152</td>
</tr>
<tr>
<td>January 1991</td>
<td>4719</td>
</tr>
<tr>
<td>May 1991</td>
<td>2677</td>
</tr>
<tr>
<td>June 1991</td>
<td>2383</td>
</tr>
<tr>
<td>July 1991</td>
<td>3313</td>
</tr>
<tr>
<td>December 1991</td>
<td>9287</td>
</tr>
</tbody>
</table>

Source: Reserve Bank of India – *Handbook of Statistics on Indian Economy, 2005 – 06*

Beginning with July 1990, India made substantial use of IMF resources (including India’s own reserve tranche(RT) holding with the IMF). Between July and September 1990, India drew down its reserve tranche\(^b\) with the IMF amounting to ₹.1177 crores. This was followed by borrowings from the IMF amounting to ₹.1450 crores under the first credit tranche(FCT) under a three month stand – by arrangement, and ₹.1884 crores under the modified Compensatory and Contingency Financing Facility (CCFF) in January 1991. In July and September 1991, further borrowings of ₹.2217 crore were made under the CCFF. In October 1991, the IMF approved an eighteen month stand – by facility for India (covering the period September 1991 to March 1993) of ₹.5700 crore. Of this, ₹.305 crores was drawn as
the first instalment or Upper Credit Tranche (Upper Credit Tranche) in November 1991. Thus, altogether, India used ₹.7033 crore of resources from the IMF between July 1990 and December 1991. Hence, a part of the increase in reserves in December 1991 can be attributed to the drawals from IMF which provided some immediate relief to the balance of payments situation.

However, as Virmani (2001) had observed “1990 – 91 was the sixth consecutive year in which reserves were drawn down to meet external payments obligations. This was one indicator of the underlying deterioration of the balance of payments that was perhaps not taken seriously enough during the second half of eighties.”

Table 6.4 gives the details of the drawals from the IMF during the period from July 1990 to December 1991.

### Table 6.4: Drawals from International Monetary Fund 1990 – 1991

<table>
<thead>
<tr>
<th>Period / Month</th>
<th>Facility</th>
<th>₹. Crore</th>
</tr>
</thead>
<tbody>
<tr>
<td>July – Sept. 1990</td>
<td>RT</td>
<td>1177</td>
</tr>
<tr>
<td>January 1991</td>
<td>FCT</td>
<td>1450</td>
</tr>
<tr>
<td>January 1991</td>
<td>CCFF</td>
<td>1884</td>
</tr>
<tr>
<td>July &amp; Sept. 1991</td>
<td>CCFF</td>
<td>2217</td>
</tr>
<tr>
<td>November 1991</td>
<td>UCT</td>
<td>305</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>7033</strong></td>
</tr>
</tbody>
</table>


### 6.2 CAUSES BEHIND THE CRISIS

The main causes behind the balance of payments crisis of 1990 – 91 were as follows

1. **Break – up of the Soviet Bloc** – Rupee trade with the Soviet Bloc was an important element of India’s total trade upto eighties. A significant proportion of trade constituting imports of capital goods and defence equipments was financed by
long term trade credits. However, the introduction of Glasnot & Perestroika and break up of the Eastern European countries led to termination of several rupee payment agreements in 1990 – 91. Thus, for instance the rupee payment agreement with the former GDR came to an end in December 1990 with the German reunification and that with Poland ended in January 1991. As a consequence of these and other political developments in Eastern Europe including USSR, the flow of new rupee trade credits declined abruptly in 1990 – 91. Further, there was also decline in our exports to Eastern Europe. For instance, exports to Eastern Europe constituted 22.1 per cent of total exports in 1980 and 19.3 per cent in 1989. But, they declined to 17.9 per cent in 1990 – 91 and further to 10.9 per cent in 1991 – 92.

(2) Iraq – Kuwait War – The Gulf crisis began with the invasion of Kuwait by Iraq at the beginning of August 1990. Crude oil prices rose rapidly thereafter. For instance, the price of crude oil rose from $ 15 per barrel in July 1990 to $ 35 per barrel in October 1990. For most countries this was a temporary shock, but for India it was not so because Iraq and Kuwait were the major sources of India’s oil imports and the war made it necessary to buy oil from the spot market. Short term purchases from the spot market had to be followed up by new long term contracts at higher prices. As a result the oil import bill increased by about 60% in 1990 – 91 and remained 40% above the 1989 – 90 level the next year. As noted in Economic Survey 1991 – 92 – “The immediate cause of the loss of reserves beginning in September 1990 was a sharp rise in the imports of oil and petroleum products. From an average of ₹.499 crore ($ 287 million) per month in June – August 1990, POL imports rose sharply to ₹.1221 crore ($ 671 million) in the following six months… The rise in the cost of POL imports more than accounted for the rise in trade deficit.
from an average of ₹.619 crore ($356 million) per month in June – August 1990 to ₹.1229 crore ($677 million) per month in the following six months.”

In addition, India’s own oil production declined because of civil disturbances in Assam, adding further to oil and petroleum product imports.

Besides this, due to substantial presence of Indian migrants in these two countries remittances from the Gulf region were adversely affected. Exports to these two countries were also affected because of the UN trade embargo. The loss of exports to West Asia was estimated to be ₹.500 crore ($280 million).

(3) Slow Growth in important Trading Partners – The deterioration of the current account was also induced by slow growth in important trading partners. Export markets were weak in the period leading up to India’s crisis, as the world growth declined steadily from 4.5 per cent in 1988 to 2.25 per cent in 1991. The decline was even greater for U.S. growth, India’s largest single export destination. U.S. growth fell from 3.9 per cent in 1988 to 0.8 per cent in 1990 and to – 1 per cent in 1991. Consequently, India’s export volume growth slowed down to 4 per cent in 1990 – 91.

(4) Political Uncertainty & Instability – The period from November 1989 to May 1991 was marked with political uncertainty & instability in India. In fact, within a span of one and half year there were three coalition governments and three Prime Ministers.

In brief, the political situation from November 1989 to May 1991 was as follows - “After a poor performance in 1989 elections, the previous ruling party (Congress), chaired by Shri. Rajiv Gandhi, refused to form a coalition government. Instead, the next largest party, Janata Dal formed a coalition government, headed by Shri.V.P.Singh. However, the coalition became embroiled in caste and religious
disputes and riots spread throughout the country. Singh’s government fell immediately after his forced resignation in December 1990. A caretaker government (headed by Shri. Chandrashekhar) was set up until the new elections that were scheduled for May 1991. These events heightened political uncertainty, which came to a head when Shri. Rajiv Gandhi was assassinated on May 21, 1991 while campaigning for elections. As a result the rest of the elections were adjourned to the period from June 12 to June 15, 1991. After the elections in June 1991, Shri. P.V. Narasimha Rao formed a minority government with Dr. Manmohan Singh as the Finance Minister.”

(4) Loss of Investors Confidence – India’s balance of payments in 1990 – 91 also suffered from capital account problems due to loss of investors confidence. The widening current account deficits and reserve losses contributed to low investor confidence, which was further weakened by political uncertainties and finally by downgrade of India’s credit rating by credit rating agencies. For instance, by March 1991, the International Credit Rating agencies (Standard & Poor’s and Moody’s) had downgraded India’s long term foreign debt rating to the bottom of investment grade. Furthermore, the credit rating went below investment grade in May (Standard & Poor) and June 1991. (Moody).

Due to the loss of investors confidence, commercial bank financing became hard to obtain, and outflows began to take place on short – term external debt, as creditors became reluctant to roll over maturing loans. Moreover, the previously strong inflows of NRI deposits shifted to net outflows.

(5) Fiscal Indiscipline – It is pertinent to note that several economists, policymakers, and the documents like Economic Survey, RBI’s Annual Report and
Report on Currency & Finance\textsuperscript{d} identified the fiscal indiscipline of the 1980s as the most important cause of balance of payments crisis of 1991.

The Economic Survey 1991 – 92 had categorically remarked that – “Throughout the eighties, all the important indicators of fiscal imbalances were on the rise. These were the conventional budgetary deficit, the revenue deficit, the monetized deficit and gross fiscal deficit. Moreover, the concept of fiscal deficit is a more complete measure of macroeconomic imbalance as it reflects the indebtedness of the Government. This gross fiscal deficit of the Central Government has been more than 8 per cent of GDP since 1985 – 86, as compared with 6 per cent in the beginning of 1980s and 4 per cent in the mid – 1970s.”\textsuperscript{11}

Further, Nayyar (1993) had critically remarked - “The origins of the crisis which surfaced in early 1991, are directly attributable to the large and persistent macroeconomic imbalances since the 1980s… The internal imbalance in the fiscal situation and external imbalance in the external situation were closely related, through the absence of prudence in the macro management of the economy”\textsuperscript{12}

The Economic Advisory Council’s report also considered ‘persistent fiscal imbalances’ as the root cause of the balance of payments problem. The Council observed that there was “excessive deficit financing” properly defined as Net RBI credit to the government, which led to inflationary pressures in the economy.

Joshi & Little (1993) have considered the marked deterioration in the public finances in the second half of 1980s responsible for the persistent current account deficits and the inflationary upsurge at the end of the decade. They also considered the crisis of 1991 as the policy induced crisis because the continuous growing fiscal deficit in the second half of 1980s was neglected by the government. Hence, the crisis was fundamentally the result of a neglect of fiscal dynamics.\textsuperscript{13}
In the context of fiscal deficits, Pangariya (2004) noted “Combined fiscal deficits at the central and state levels, which averaged 8 per cent in the first half of the 1980s went up to 10.1 per cent in the second half. Continued large deficits of this magnitude led to a build up of very substantial public debt with interest payments accounting for a large proportion of government revenues. They also inevitably fed into the current account deficits, which kept rising steadily until they reached 3.5 per cent of GDP & 43.8 per cent of exports in 1990 – 91. The eventual outcome of these was June 1991 crisis.”

In a nutshell, it is clear that the problems of the economy, which reached crisis proportions in 1991, did not come as a bolt from the blue. This problems got accumulated over several years. Furthermore, the fiscal crisis was neither an accident nor a coincidence but it was a direct consequence of financial profligacy on the part of the government.

(6) Increase in Non – Oil Imports - The trends in imports and exports show that imports rose much faster than exports during the eighties. For instance, during the eighties, imports increased by 2.3 per cent of GDP, while exports increased by only 0.3 per cent of GDP. As a consequence, trade deficit increased from an average of 1.2 per cent of GDP in the seventies, to 3.2 per cent of GDP in eighties. However, it is important to note that the rise in trade deficit was mainly due to sharp rise in non – oil imports which were the focus of import liberalization policies in eighties. No doubt oil imports (due to second oil shock 1979) contributed to the total import bill but only marginally. The data of imports (oil and non –oil) from 1981 – 82 to 1990 – 91 confirms this point. It is clear from table 6.5 that from 1981- 82 to 1985 – 86, out of total imports, oil and non – oil imports constituted 32 and 68 per cent respectively. While, from 1986 – 87 to 1990 – 91, oil imports constituted only 19
per cent of total imports and non-oil imports constituted 81 per cent of total imports. Thus, throughout the 1980s increase in non-oil imports can be considered as one of the factors leading to increase in trade deficit.

Table 6.5: Oil and Non–Oil Imports

<table>
<thead>
<tr>
<th>Period</th>
<th>Oil Imports</th>
<th>Non–Oil Imports</th>
<th>Total Imports</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981-82 to 1985</td>
<td>26041.61</td>
<td>54491.03</td>
<td>80532.64</td>
</tr>
<tr>
<td>1985-86</td>
<td>(32.00)</td>
<td>(68.00)</td>
<td></td>
</tr>
<tr>
<td>1986–87 to 1990</td>
<td>28299.75</td>
<td>120796.18</td>
<td>149095.93</td>
</tr>
<tr>
<td>1990-91</td>
<td>(19.00)</td>
<td>(81.00)</td>
<td></td>
</tr>
</tbody>
</table>

Note: Figures in brackets are percent to total.

Source: Reserve Bank of India – *Handbook of Statistics on Indian Economy, 2005–06*

(7) Decline in Invisibles - A more important component which affected the current account adversely was the decline in invisibles in the second half of the eighties. In this context, *Economic Survey 1990–91* noted –“The crux of the balance of payments problem during the recent years has been the large and persistent trade deficit and the declining capacity of invisibles to finance this deficit.”15 Thus, the net invisibles as a percentage to GDP declined from an average of 2.2 per cent during the Sixth plan (1980–85) to 1 per cent during the Seventh plan (1985–90).

The accrual of surpluses in invisibles account became increasingly insufficient for covering the trade gap. For example, during the Sixth plan period (1980-85) invisibles financed on an average 55 per cent of trade gap. The respective figure for Seventh Plan period stood at 25 per cent.

(8) Rise in External Debt - It is beyond doubt that in the second half of the eighties the current account deficit was showing a rising trend and was becoming unsustainable. Yet another important issue was the way in which this deficit was being financed.
The current account deficit was mainly financed with costly sources of external finance like – external commercial borrowings, NRI deposits, etc.

In the context of external debt the following observations are worth considering:

- The grant component in the overall external assistance showed a declining trend. For example, up to the Fourth Plan period, the grant component accounted for an average of 28 per cent of overall external assistance. It declined to 21 percent in the later half of seventies and further to 16 per cent in the earlier half of eighties. During 1985 – 86 to 1990 – 91, it declined further to 11 per cent.

- The period of eighties was marked by a reduction in flows of concessional assistance to India, principally from the World Bank Group. For instance, the loans on soft terms from the International Development Assistance (IDA) declined while the loans on market terms from the World Bank increased sharply. For instance, in 1980 disbursements on concessional terms constituted more than 89 per cent of assistance to India from multilateral sources; in 1990, this proportion declined to about 35 per cent.\(^{16}\)

- Due to a decline in concessional assistance there was a rise in average interest cost of external borrowing.

- There was also a decline in the average maturity period of loans. The average maturity of loans from official creditors (including bilateral sources) also declined from 40.8 years in 1980 to 29.1 years in 1990.\(^{17}\)

- The average maturity period for External Commercial Borrowings (ECBs) was five years and for NRI deposits was one year.
There was a change in the composition of debt as it shifted from official to private sources like external commercial borrowings (ECBs) and NRI deposits. These private sources were more costlier.

The external debt was funneled into financing the government’s deficit.

The ratio of short-term debt to total debt is considered as an important debt indicator. However, up to the end of eighties, the data on short-term debt was not available in any Indian publication. The ratio of short-term debt to total debt was 6.1 per cent in March 1989, which reached to 9.9 per cent by March 1990, and further it increased to 10.2 per cent by March 1991. Thus, it was signaling that a BOP crisis had been brewing for more than a year.

The short term debt to foreign currency ratio increased from 0.9 in March 1989 to 2.2 in March 1990 and further to 3.8 in March 1991. Thus, the rise in this ratio was signaling a BOP crisis.

With respect to external debt it was observed that, India’s external debt increased from 194.70 crore (US $ 23.50 billion) in 1980 – 81 to ₹ 459.61 crore (US $ 37.50 billion) in 1985 – 86. It went up to ₹ 1003.76 crore (US $ 58.63 billion) in 1989 – 90. In 1990 – 91, it was ₹ 1229.50 crore (US $ 63.40 billion).18

The total debt as a per cent of GDP was 13.7 in 1980 – 81, 17.4 in 1985 – 86, and 21.4 in 1990 – 91.

The increase in external debt sharply raised the debt service ratio during the period. For instance, debt service as a per cent of exports of goods and services, increased from 9.3 per cent in 1980 to 18.2 per cent in 1984 and further to 26.8 per cent in 1990. The debt service as per cent of current receipts was 9.3 in 1980 – 81, 16.7 in 1985 – 86, and 24.7 in 1990 – 91.19
Thus, the balance of payments situation came to the verge of collapse in 1991, but this was only to be expected. It was mainly because the current account deficits were mainly financed by borrowing from abroad. The ultimate result was a continuous rise in external debt and debt service burden of the nation.

**9. Overvaluation of Exchange Rate** – Some of the economists have also argued that overvaluation of exchange rate was a cause of the balance of payments crisis of 1990 – 91.

As Joshi & Little (1993) have pointed out – “From 1982 to 1985, the persistent current account deficit was the result of almost complete stagnation of exports which was in turn largely the result of an inappropriate exchange rate policy. The real exchange rate was allowed to appreciate by about 15 per cent from 1979 -81 and remained at that level for next four years.”

According to Virmani (2001) the most readily available indicator signaling an overvaluation of rupee from the overall perspective of the balance of payments was the foreign exchange reserves. Reserves after building up for three years declined in 1985 – 86. This decline continued through the rest of the eighties. Thus, the average reserve usage increased from 0.1 per cent of GDP in the first half of the eighties to an average of 0.3 per cent of GDP during the second half of the eighties. By the end of eighties (1989 – 90) therefore, there was an evidence of overvaluation from the overall perspective of balance of payments. Further, the external economic shocks resulted in a sharp deterioration of both the current account and the ‘normal capital flows’ (excluding other capital) in 1990 – 91. The gap between these opened up in 1991 – 92 to reach 1.5 per cent of GDP. The current account deficit increased from 2.5 per cent of GDP in 1989 – 90 to 3.0 per cent of GDP in 1990 – 91, while the
normal capital flows declined from 2.2 per cent of GDP in 1989-90 to 1.5 per cent in 1990-91. As a result, the overvaluation of the rupee increased.21

To sum up, the causes behind the balance of payments crisis of 1990-91 were external as well as internal. The important external causes were – break down of Soviet bloc and Iraq – Kuwait war. While the important internal causes were – fiscal indiscipline, political uncertainty and instability, loss of investor’s confidence, fall in invisibles surplus and rising external debt. However, the external shocks played only a minor role in the crisis. The cut off of foreign lending was not an exogenous shock but a reaction to the unsound macroeconomic position. Hence, macroeconomic imbalances can be considered as the major cause behind the crisis.

6.3 POLICY MEASURES TO OVERCOME THE BOP CRISIS

The strategy of reforms introduced in India in July 1991 presents a mixture of macroeconomic stabilization and structural adjustment. It was guided by short – term and long – term objectives. Stabilization was necessary in the short – run to restore balance of payments equilibrium and to control inflation. At the same time reforms were equally important from long term point of view.

Thus, the new Government which assumed office in June 1991 had to act swiftly to deal with the situation and bring the economy back from the brink of default in payments. The Government leased 20 tonnes of gold out of its stock to the State Bank of India to enable it to sell the gold abroad with an option to repurchase it at the end of six months. This export took in the month of May 1991. In addition, the Government allowed RBI to ship 47 tonnes of gold to the Bank of England in July 1991. This helped to raise about $ 600 million.
It was evident that the economy needed substantial reforms if the crisis was to fully overcome. The new Government moved urgently to implement a programme of macroeconomic stabilization through fiscal correction. Besides this, structural reforms were initiated in the field of trade, industry and public sector.

6.3.1 Major Policy Measures Introduced

The major policy initiatives taken by the Government to fundamentally address the balance of payments problem and the structural rigidities were as follows:

1) Fiscal Reforms – A key element in the stabilization effort was to restore fiscal discipline. Greater the fiscal deficit, larger is the government borrowing from RBI. The greater the amount of borrowing, the larger is the money supply and higher is the rate of inflation. Similarly, fiscal deficit is closely linked with the worsening of balance of payments. Expansion in aggregate money supply and aggregate demand results in higher import demand. On the other hand, inflation and thereby increased costs of production reduces the competitiveness of exports results in a trade deficit. Fiscal deficit also leads to greater external borrowings and sometimes commercial borrowings. As a result, servicing of debt becomes difficult. The outflow of foreign exchange reserves has an adverse affect upon the balance of payments.

The data reveals that fiscal deficit during 1990-91 was as large as 8.4 per cent of GDP. It was over twice the level of mid-1970s and over one and half times the 1981-82 level. Hence, the aim of fiscal reform was to correct fiscal imbalances. The regular Budget for 1991 – 92 took a bold step in the direction of correcting fiscal imbalance. It envisaged a reduction in fiscal deficit by nearly two percentage points of GDP from 8.4 per cent in 1990 - 91 to 6.5 per cent in 1991 - 92. This involved a fiscal correction of nearly ₹.12,000 crore. The budget laid stress on fiscal adjustment being supported by essential reforms in economic policy and management. While it
contained proposals for raising additional revenue, most of the reduction in fiscal
deficit was sought to be achieved through reduction in non-plan expenditure. The
budget aimed at containing Government expenditure and augmenting revenues;
reversing the downtrend in the share of direct taxes to total tax revenues and curbing
conspicuous consumption. Some of the important policy initiatives introduced in the
Budget for the year 1991 – 92 for correcting the fiscal imbalance were as follows:

- Reduction in fertilizer subsidy;
- Abolition of Cash Compensatory Support for exports;
- Abolition of subsidy on sugar;
- Disinvestment of a part of the government’s equity holdings in select public
  sector undertakings; and
- Acceptance of major recommendations of Tax Reforms Committee headed
  by Raja Chelliah in order to raise revenue through better compliance in case
  of income tax, excise and customs duties and make the tax structure stable
  and transparent.

2) Monetary & Financial Sector Reforms – The second set of reforms was carried
in the monetary and financial sector. Monetary reforms aimed at doing away with
interest rate distortions and rationalizing the structure of lending rates. In the pre-
reform period, government borrowing was done at administered rates while the
lending rates for commercial sector were very high. The new policy attempted to
apply market related rates to government borrowing, an appropriate example was
364 days treasury bills. Besides this, it tried to reduce the number of lending rates
from six to two, one being the general rate, and the other being the concessional rate
for weaker sections of the society.
The monetary policy reforms went for reduction in statutory liquidity ratio (SLR) and the cash reserve ratio (CRR) in line with the recommendations of the Narasimham Committee Report, 1991. During mid-1991 SLR and CRR were very high. It was proposed to cut down SLR from 38.5 per cent to 25 per cent within a time span of three years. Similarly, CRR was proposed to bring down to 10 per cent over a period of four years.

Besides this, the new policy tried in many ways to make the banking system more efficient. Some of the measures undertaken were –

- Greater competition among public sector, private sector and foreign banks and elimination of administrative constraints;
- Liberalization of branch licensing policy in order to rationalize the existing branch network;
- Banks were given freedom to relocate branches, open specialized branches, and set up controlling offices;
- Setting up of special tribunals for loan recovery;
- Guidelines for opening new private sector banks; and
- New accounting norms regarding classification of assets and provisions of bad debt were introduced in tune with the Narasimham Committee Report.

Reforms were not restricted to banking sector alone. They were introduced in the capital market as well. For instance, Capital Issues (Control) Act, 1947 was repealed and the Office of the Controller of Capital Issues was abolished. With this, companies no longer needed government approval for approaching the capital market. The companies issuing securities were free to fix issue price and premium. The companies were also permitted to approach international capital market through
the issue of Global Depository Receipts (GDR) and American Depository Receipts (ADR).

The Securities & Exchange Board of India (SEBI) which was set up in 1988 was given statutory recognition in 1992 on the basis of recommendations of the Narasimham Committee. Among other things, SEBI has been mandated to create an environment which would facilitate mobilization of adequate resources through the securities market and its efficient allocation. Some of the important objectives of SEBI are as follows:-

(a) Regulating the business in stock market and other intermediaries associated with securities market;

(b) Registering and regulating mutual funds;

(c) Promoting and regulating the self – regulatory organizations;

(d) Prohibiting fraudulent and unfair trade practices relating to securities markets;

(e) Prohibiting insider trading in securities; etc.

3) Industrial Policy Reforms – In order to consolidate the gains already achieved during the 1980s, and to provide greater competitive stimulus to the domestic industry, a series of reforms were introduced in Industrial Policy. The government announced a New Industrial Policy on July 24, 1991. The New Industrial Policy 1991, sought substantially to deregulate industry so as to promote growth of a more efficient and competitive industrial economy. The central elements of industrial policy reforms were as follows –

(a) Industrial licensing was abolished for all projects except in 18 industries where strategic or environmental concerns are paramount or where industries produced
goods with exceptionally high import content. With this, 80 per cent of the industry was taken out of the licensing framework.

(b) The Monopolies & Restrictive Trade Practices (MRTP) Act was repealed to eliminate the need for prior approval by large companies for capacity expansion or diversification.

(c) Areas covered reserved for the public sector were narrowed down, and greater participation by private sector was permitted in core and basic industries. Earlier, 17 industries were reserved for public sector. The new policy reduced this to number 8. These eight are mainly those involving strategic and security concerns.

(d) Government clearance for the location of the projects was dispensed with except in case of 23 cities with a population of more than one million.

(e) The requirement of phased manufacturing programmes was discontinued for all new projects.

(f) The policy encouraged disinvestment of government holdings of equity share capital of public sector enterprises. This was initially in favour of mutual funds, and other institutions, but later, in favour of general public.

(g) The public sector units were provided greater autonomy and professional management that could be helpful for generating reasonable profits, through an MOU between the enterprise and the concerned Ministry.

4) Trade Policy Reforms — Considering the roots of crisis of 1991 in the international sector, it was but natural that the main focus of economic reforms was on trade and capital flows. Under trade policy reforms, the main focus was on greater openness. Hence, the policy package was essentially an outward–oriented one. New initiatives were taken in trade policy to create an environment which
would provide a stimulus to export while at the same time reducing the degree of regulation and licensing control on foreign trade.

The main features of the new trade policy as it has evolved over the years since 1991 are as follows:

(A) **Freer imports and exports**: In the pre-reform period, India’s trade policy regime was complex and cumbersome. There were different categories of importers, different types of import licences, alternate ways of importing etc. However, substantial simplification and liberalization has been carried out in the post – reform period.

In July – August 1991, a freely tradable import licence known as “Exim scrip” was introduced with a premium in the market. For most exports a uniform rate of 30 per cent of Exim scrips was made applicable, though some exports were entitled to higher rates. This scheme was withdrawn after the introduction of liberalized exchange rate management system (LERMS), in March 1992. With the introduction of Exim scrips, in 1991, the existing Cash Compensatory System (CCS) was abolished.

Prior to 1991, in India imports were regulated by means of a positive list of freely importable items. From 1992, imports were regulated by a limited negative list. For instance, The trade policy of April 1,1992, freed imports of almost all intermediate and capital goods. Only 71 items remained restricted. Special Import Licence (SIL) was given to star exporters for importing restricted items. Further, the trade policy of April 1,1993 removed 146 items from the negative (restricted) list of exports. In April 1994 policy the scope of SIL was expanded and second hand capital goods were allowed to be imported. The import policy of April 1995 put 78 consumer goods in the freely importable category.
(B) **Rationalization of tariff structure & removal of quantitative restrictions** - The Chelliah Committee’s Report had suggested drastic reduction in import duties. It had suggested a peak rate of 50 per cent. As a first step towards a gradual reduction in the tariffs, the 1991-92 budget had reduced the peak rate of import duty from more than 300 per cent to 150 per cent. The process of lowering the customs tariffs was carried further in successive budgets.

Apart from tariff cuts, quantitative restrictions (QRs) were removed from the import of many items, especially capital goods and intermediaries. Thus, by the year 2001-02, in line with the India’s commitment to WTO, quantitative restrictions on all import items have been withdrawn.

(C) **Decanalisation** – A large number of exports and imports were used to be canalized through the public sector agencies in India. The supplementary trade policy announced on August 13, 1991 reviewed these canalized items and decanalised 16 export items and 20 import items. The process of decanalisation was carried further from time to time.

(D) **Trading Houses** – The 1991 policy allowed export houses and trading houses to import a wide range of items. The Government also permitted the setting up of trading houses with 51 per cent foreign equity for the purpose of promoting exports. For instance, under the 1992 – 97 trade policy, export houses and trading houses were provided the benefit of self certification under the advance license system, which permits duty free imports for exports.

(E) **Concessions and Exemptions** – A large number of tax benefits and exemptions have been granted during the 1990s to liberalize imports and promote exports with the five year Exim policy 1992 – 97 and Exim policy 1997 – 2002 serving as the basis for such concessions. These policies, in turn, have been reviewed and modified
on an annual basis in the Exim policies announced every year. Successive Union budgets have also extended a number of tax benefits and exemptions to exporters. For instance, reduction in the peak rate of customs duty to 10 per cent, reduction in the duty rates for critical inputs for information technology sector, etc.

5) *Promoting Foreign Investment* – The government took several measures to promote foreign investment in India in the post-reform period. Some of the important measures are –

(a) In 1991, the government announced a specified list of high technology and high investment priority industries wherein automatic permission was granted for foreign direct investment (FDI) up to 51 per cent foreign equity. The limit was raised to 74 per cent and subsequently to 100 per cent for many of these industries. Moreover, many new industries have been added to the list over the years.

(b) Foreign Investment Promotion Board (FIPB) has been set up to negotiate with international firms and approve direct foreign investment in select areas.

(c) Steps were also taken from time to time to promote foreign institutional investment (FII) in India.

6) *Rationalization of Exchange Rate Policy* – One of the important measures undertaken to improve the balance of payments situation was devaluation of rupee. In the very first week of July 1991, the rupee was devalued by around 20 per cent *vis-a-vis* a basket of five currencies, viz. the US dollar, the Deutschemark, the British pound, the French Franc, and the Japanese Yen. The purpose was to bridge the gap between the real and the nominal exchange rates that had emerged on account of rising inflation and thereby to make the exports competitive.

The Finance Minister announced the Liberalized Exchange Rate Management System (LERMS) in the Budget of 1992 – 93. This system introduced partial
convertibility of rupee. Under this system, a dual exchange rate was fixed under which 40 per cent of foreign exchange earnings were to be surrendered at the official exchange rate, while the remaining 60 per cent were to be converted at market determined exchange rate. The foreign exchange surrendered at official rate was to be used for the import of essential items like - crude oil, petroleum products, fertilizers, life saving drugs, etc. and the foreign exchange converted at market exchange rate was to be used to finance all other imports. The LERMS was essentially a transitional mechanism and provided a fair degree of stability which provided a healthy build – up of reserves. The main objectives behind the introduction of LERMS were the fulfillment of the need for a market-oriented and flexible exchange rate mechanism as a means to achieve self –reliance through improved export performance and a reduction in the scope of illegal transactions in foreign exchange so that the flow of inward remittances into the country can be increased substantially. The dual exchange rate system was followed for a very short period of one year.

From March 1993 onwards, an important step was taken towards full convertibility of rupee viz. unification of exchange rate. Under the unified exchange rate regime adopted in the 1993 – 94 Budget, the 60 : 40 ratio was extended to 100 per cent conversion Thus from March 1993 onwards, market determined exchange rate system was followed. This transition to market based system was based on the recommendations of a High Level Committee on Balance of Payments chaired by Dr. C. Rangarajan. Favouring a realistic exchange rate, the Committee recommended unification of exchange rate as an important step towards full convertibility of rupee. Current account convertibility was finally achieved in August 1994 when the Reserve Bank further liberalized payments and accepted
obligations under Article VIII of the IMF, under which India is committed to forsake the use of exchange restrictions on current international transactions as an instrument in managing the balance of payments. In brief, the market determined exchange rate regime being followed by India since 1993 is a ‘managed float’ regime.

7) Approach towards Capital Account Convertibility – On account of the dangers of full capital account convertibility and the unhappy experience of other countries who opted for such convertibility, the RBI opted for a gradualist and phased capital account liberalisation programme. The framework of Reserve Bank’s approach to capital account convertibility was provided by the Report of the Committee on Capital Account Convertibility (Chairman – S. S. Tarapore) submitted in May 1997. The Committee defined Capital Account Convertibility (CAC) as “the freedom to convert local financial assets into foreign financial assets and vice-versa at market determined exchange rates.” The Committee recommended phased liberalization of controls on outflows and inflows over a three year period (1999 – 2000). The Committee had laid down three crucial pre-conditions for attaining CAC, like – (a) fiscal consolidation, (b) a mandated inflation target and (c) strengthening of the financial sector. As a prerequisite for CAC, the Committee had laid down that the CAD should not exceed 1.6 per cent of GDP and the combined fiscal deficit of Centre & States should be around 3.5 per cent of GDP. In addition, the Committee stressed that important macroeconomic indicators should also be assessed on an on-going basis.

In due course, Reserve Bank constituted another Committee on capital account convertibility again under the Chairmanship of S. S. Tarapore. The Committee submitted its Report on Fuller Capital Account Convertibility (FCAC) on 31st July
2006. The Committee gave a five year time frame for movement towards fuller convertibility in three phases: Phase I (2006–07); Phase II (2007–08 to 2008–09); and Phase III (2009–10 to 2010–11). The Committee suggested various concomitants for a move towards fuller capital account convertibility like – (a) meeting Fiscal Responsibility and Budget Management (FRBM) targets, (b) shifting from the present measure of fiscal deficit to a measure of Public Sector Borrowing Requirements (PSBR), (c) segregating government debt management and monetary policy operations through the setting up of the Office of Public Debt independent of the Reserve Bank, (d) keeping the CAD / GDP ratio under 3 per cent; and (e) evolving appropriate indicators of adequacy of reserves to cover not only import requirements, but also liquidity risks associated with present types of capital flows, short term debt obligations and broader measures of solvency.

Over a period of time, several steps have been taken to liberalize the capital account.

**6.4 SUMMARY**

Macroeconomic crisis in a country is the one which generally takes the form of accelerating inflation and unsustainable fiscal and current account deficits. India’s balance of payments started deteriorating in Seventh Plan and reached to a critical position in the year 1990–91. Seventh Plan onwards ultimately reached to a critical position in the year 1990–91. Hence, the year 1990–91 can be considered as the most difficult year from India’s balance of payments point of view.

Some of the basic features which indicated the presence of BOP crisis were – high inflation, large fiscal and current account deficits, increasing burden of external debt, fall in GDP growth rate & industrial growth rate, a steep fall in foreign exchange reserves, downgrading of country’s credit rating, etc.
The causes behind the balance of payments crisis of 1990–91 were external as well as internal. Some of the important external causes were - break down of Soviet bloc and Iraq – Kuwait war. While some of the important internal causes were – fiscal indiscipline, political uncertainty and instability, loss of investor’s confidence, fall in invisibles surplus and rising external debt.

To overcome the crisis a program of macroeconomic stabilization and structural adjustment was introduced in July 1991. Major reforms were introduced in fiscal, financial, industrial and trade sectors. The aim of fiscal reforms was to correct fiscal imbalances and restore fiscal discipline. The Budget for 1991–92 aimed at containing Government expenditure especially non-plan expenditure and augmenting revenue. The monetary policy reforms included – reduction in SLR and CRR, rationalizing the structure of interest rates, etc. Reforms were also introduced in the banking sector on the basis of recommendations of Narasimham Committee. Some of them were – liberalization of branch licensing policy, guidelines for opening of new private sector banks, encouraging competition among banks, etc. In the financial sector, to regulate the capital market SEBI (which was established in 1988) was granted statutory recognition in 1992.

A series of reforms were introduced in the industrial sector. For instance, the New Industrial Policy introduced in July 1991 aimed at deregulation of industry in order to promote growth in the industrial sector. Besides this, industrial licensing was abolished for major industries, MRTP Act was amended, and disinvestment of public sector enterprises was also undertaken.

The main reforms were related to trade sector with an emphasis on greater openness. Some of the major trade policy reforms undertaken were – freer imports and exports, rationalization of tariff structure, removal of quantitative restrictions, decanalization,
etc. Steps were also taken to promote foreign investment through foreign direct investment and foreign institutional investment. One of the important measures undertaken to improve the balance of payments situation was devaluation of rupee. In the very first week of July 1991, the rupee was devalued by around 20 per cent in relation to major currencies. Exchange rate policy was rationalized by adopting a market determined exchange rate system from March 1993. With respect to capital account convertibility, a gradualist and phased capital account liberalization program has been adopted. The approach towards capital account convertibility has been on the basis of recommendations of Tarapore Committee – I (1997), and Tarapore Committee – II (2006).

NOTES & REFERENCES

NOTES


b. The reserve tranche holdings of a member country with the IMF constitute a part of the country’s own reserves. The reserve tranche drawings are similar to drawdown of a country’s reserves and they need not be repaid.


REFERENCES


17. *Ibid*, p. 188.

