The Long Road to the 1991 Economic Crisis

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Before 1991, all major post-Independence economic crises in India were caused by exogenous forces—the contribution of policy errors towards their exacerbation notwithstanding—whether by war or drought or global commodity shocks. Not the 1991 crisis.

In their seminal study of the Indian economy, Joshi and Little **called the**1991 crisis a "policy-induced crisis par excellence". It did not develop overnight. Crises rarely do. It was caused by more than a decade of imprudence. The 1979 budget was a turning point from the relative conservatism of previous fiscal management. Over the next decade, the twin—current and fiscal—deficits widened continuously. Here I examine the long road to the economic disaster that shook India in 1991.

The 1979-81 crisis

Fiscal policy was already pretty loose going into the summer of 1979, when India suffered the worst drought since Independence and the global oil shock (caused by the Islamic Revolution in Iran).

The Seventh Finance Commission (1977) recommended a rather large increase in the states' share of the central government's tax revenues without **any reduction** in the centre's responsibilities. The central government's fiscal deficit **increased** , but these transfers were only a small part of the problem.

A **new** "political awakening" and "political decay" took their toll on the public purse. The former refers to the self-awakening and political assertion of hitherto silent groups such as farmers, who formed the backbone of many parties in the Janata coalition. The latter refers to a decline in the capacity of political institutions in addressing those demands legitimately or satisfactorily. Reliance on short-term populist measures, mostly in the form of government largess, followed from this decay.

This period saw a rise in foodgrain procurement prices (without any increase in issue price) and tax deduction on agriculture inputs. Fertilizer subsidies increased tenfold (from Rs60 crore to Rs600 crore) during the Janata government (1977-80). Food and export subsidies grew rapidly as well.

The fiscal deficit, which had averaged below 5% for most of the 1970s, rose to 5.7% and 6.5% in the last two years of Janata government. A greater interest payment

burden due to a combination of wider primary deficit (fiscal deficit excluding interest payments) and higher cost of borrowing, strong growth in public sector employment and wages, bailout of loss-making public sector firms and slower growth in government revenue made the situation worse. The only mitigating factor was a scaling back of public investment—partly out of budgetary constraints and partly out of policy paralysis.
Meanwhile, gradual import liberalization from 1976 onwards had quite expectedly manifested itself in the rapid growth of imports, especially that of intermediate and capital goods. Unfortunately, export growth failed to keep up. International aid and loans started drying up after 1976 as well. For the time being, bourgeoning remittance flows from workers in the Persian Gulf plugged the current account hole and facilitated a strong build-up of foreign reserves—there was more than $7 billion in reserves by 1978, which was enough to pay for nine months of imports.

On the flip side, this unsterilized reserve accumulation reflected in an increase in total money supply (dollar inflows were accumulated by the central bank, while it paid out rupees in exchange). The broad money growth—averaging 20% during the Janata years—was further fuelled by increased Reserve Bank of India (RBI) overdraft to the central and state governments.

The severe drought and the global oil shock of 1979 came in this backdrop of fiscal irresponsibility, rapid monetary expansion and political instability (the Janata government had split and was on its way out by then). While agricultural and foodgrain production fell by a sixth, terms of trade (the ratio of export to import prices) deteriorated by a third due to the oil price spike and the current account deficit deteriorated from 4% (1978-79) of exports to 31% (1981-82).

Disturbances in Assam curtailed the domestic oil supply as well. Inflation, already starting to react to pent-up money growth, accelerated—the wholesale price index reached high teens.

Fortunately, lessons from previous crises had been learnt, and even though food prices rose, the government had accumulated enough foodgrain reserves to avoid a severe food crisis. Alongside, prudent accumulation of foreign exchange reserves over the preceding years allowed the government to avoid import suppression. Nevertheless, the situation was grim, with fuel shortages leading to a power and transport crunch. Historical deficiencies in infrastructure began to bite harder. An industrial recession followed.

In a departure from the policy reaction to previous crises, the government sought to bring about an “expansionary adjustment”, i.e., an increase in investments—especially in developing the energy sector, exports, growth and savings—instead of the usual restraint in fiscal spending or imports. To help finance this package, the government was forced to approach the International Monetary Fund in 1980.
Later that year, India and the IMF started negotiations for a larger loan—to the tune of a billion dollars—to pre-empt the funding needs of the sixth Five-Year Plan. Rather than

advocating fiscal restraint as usual, the IMF helped finance the successful development of the Oil and Natural Gas Commission, or ONGC.
To avoid giving the impression of acting under duress, and also to allay the Fund's concerns over the government's intent to mobilize domestic resources, a tough budget was presented in 1981. Apart from raising indirect taxes, administered prices for several commodities were raised. Sadly, the 1981 budget was a one-off and the deficit remained at the higher end of 8-11% of GDP for the next decade.

Public finances in the 1980s

Once a deal with the IMF had been negotiated and the crisis deal with, the finance ministry was back on its journey to financial ruin in 1982. The fiscal deficit of the consolidated government, which had averaged 4.75% of GDP in the decade before 1979, averaged 9% in the decade after—the average masks the deterioration of the Rajiv Gandhi years (1985-89), when it averaged 10%.

What were the factors that led to this?

Deviating from the Janata years, there was now a welcome focus on public investment under Indira Gandhi (1980-84). Averaging below 8% of GDP for the decade before 1979, public investment averaged well above 10% during the next 10 years.
Unfortunately, the expenditure was not compensated either by revenue mobilization or by savings elsewhere—in fact, current expenditure exploded from 15% of GDP in the 1970s to 21% in the 1980s. Had it not been for the new-found profitability of the revived state-owned oil enterprises, public sector saving would have declined rather than just stagnating.

During the Rajiv Gandhi years, there was some uptick in revenue, but due to higher projectionist tariffs, rather than the official story of a Laffer curve-like effect —total tax collection supposedly increases with a cut in tax rates as people are incentivized to work more—in the wake of income and corporate tax cuts.

The deficit was financed by a combination of external borrowings from the IMF, the World Bank and commercial sources, as well as the crowding out of the private sector—higher bank reserve requirements to forcibly accommodate government borrowing needs reduced credit availability for the private sector—and deficit monetization (essentially money printing by the RBI).

Fear of stoking inflation had meant that the reliance on the RBI was not complete—the central bank's credit to government as a percentage of gross fiscal deficit, in fact, **fell from** 49% to 22% between 1980 and 1989—and external sources had to be explored. Public sector enterprises were allowed to raise bank loans abroad. High domestic interest rates compared to the global financial markets made this a particularly attractive option. Expansionary fiscal policies and a desire to attract NRI deposits had kept domestic interest rates high.

Global lenders, reeling from a series defaults in Latin America during the late 1970s to the early 1980s (the so-called LDC crisis), were looking for solvent creditworthy borrowers and India stood out. In the course of my interviews with bureaucrats of that era, I even came across speculations that Indian public sector managers may have received kickbacks from foreign lenders—particularly Japanese investors flush with cash—to make them take on more foreign debt. Thus, external debt financing of fiscal deficits was not difficult despite the decline in foreign aid, which **fell from** 75% of the current account deficit in 1980s to just 22% by 1990-91.

However, external commercial or non-concessional borrowing, as the name suggests, was costlier. Worsening terms of borrowing tripled debt servicing costs—debt service payments to current account receipts—during the decade, which **rose from** 10% in 1980-81 to 30% in 1990-91. By the end of the 1980s, government of India's total interest spending was more than that on defence or subsidies.
All of this would spill over into the balance of payments.

Balance of payments in the 1980s

A modest pre-crisis current account surplus that was turned into a deficit in 1979 remained so and continued to deteriorate throughout the 1980s, peaking at 3.5% of the GDP in 1990-91. Using current account deficit as a percentage of exports rather than GDP, a more suitable metric for India given the meagre foreign earnings, the situation looked even starker. The current account deficit remained between 40% and 50% of the exports during the second half of the 1980s, implying that foreign exchange earnings could cover only about 50-60% of foreign currency expenses. As a result, total external liabilities more than doubled as a percentage of the gross national income—from 11% to 26%—between 1980 and 1990. Almost half of these liabilities **were owed** by the public sector.

There has been a debate over how much did the liberalization of the trade and industry regime—rather than just the fiscal deficit—contributed towards the balance of payment crisis by facilitating a surge in imports. An argument blaming liberalization finds resonance especially among those who are on the left of the political-ideological spectrum, and also among Congress apologists.

However, a closer look at the **data suggests** that the import intensity of domestic production hardly changed during the decade. Since imports remained within the 8-9% range of GDP, it was the growth in overall output that drove the surge in imports.
The nature of import liberalization was such that it only made the processes less cumbersome, and imports were still mostly confined to essentials. Therefore, the root of the balance of payment crisis lay in, first, the investment-savings deficit driven by fiscal profligacy; second, the reliance on non-concessional external borrowing to fund that deficit; and finally, the inability of export growth to keep pace with the growth in imports—i.e., a direct fallout of an economic growth model driven by public-borrowing-financed domestic demand.

The development of domestic oil supplies in the aftermath of the crisis was a definite positive for the balance of payments. Domestic crude oil production doubled between 1981-82 and 1984-85, and its share of total domestic oil consumption rose from just below 50% to 75%, relieving pressure on the import bill. Some of the latter was also down to consumption suppression and the decline in global oil prices.

Nevertheless, the export performance in the first half of the 1980s was bad enough for the current account to remain in deficit. While the global economy had been hit by a demand shock, Indian export performance was much worse than its peers. Real appreciation of the rupee was an import factor behind this, which in turn was caused by high inflation and institutional unwillingness to adjust the nominal exchange rate accordingly (the currency should ideally depreciate to compensate for domestic inflation to keep it competitive globally).

This attitude changed later in the decade, and the rupee's real depreciation along with a revival in the global economy reflected in the improvement in export performance. However, it was insufficient to keep up with import expenses.

On top of that, the growing—and costlier—external debt manifested itself in higher interest payments. Standing at $4 billion in 1990-91, net factor income (a negative income that was largely made up of interest payments to global lenders) accounted for almost half of the current account deficit.

Institutional response

The RBI was tasked with taking care of the consequences of the government's fiscal delinquency. In its official **institutional history** , the central bank takes great pains to highlight the instances when respective RBI governors issued polite warnings to the government.

Manmohan Singh (governor for 1982-85) and R.N Malhotra (1985-90) from time to time raised concerns over the rapid growth in monetary base due to government spending, the resultant threat to price stability, rising external deficits and the crowding out of credit to the private sector. These warnings fell on deaf ears as the finance ministry emphasized the urgent developmental and defence needs of the country.

In a typical example of government's bluster, finance minister V.P. Singh **said in** 1985 that the Indian economy could absorb substantially higher deficit financing that what "traditional economic theories and analysis would permit".

Budget speeches for most of those years do not betray any sense of worry or concern over the rising imbalances. In the budget speech **delivered** in early 1986, V.P. Singh boasted that the government's record on keeping "external borrowings at prudent level... has been enviable".

Prime minister Rajiv Gandhi took over the finance portfolio by the next budget, when **he claimed** that "We have avoided debt problems", even as he conceded that "The deficit is high and I do not like it."

India again had a full-time finance minister in the form of N.D. Tiwari by the next budget. However, there was still no change in attitude, with the 1988 **budget claiming** proudly that "India has followed a prudent policy in debt management and has avoided problems of the kind faced by several other developing countries."

The 1989 budget, presented by yet another new face, Shankarrao Chavan, did express concerns over the fiscal and current account deficits and external debt (Shankarrao Chavan). However, as the 1990 budget pointed out, little was done to remedy the situation and as with previous budgets there was significant spending overruns.

A new government was in place by 1990 and the debt-servicing situation was becoming too difficult for the government to ignore. The new finance minister, Yashwant Sinha, declared that "(w)e could have postponed these options only at the peril of our economic independence and self-reliance" in order to justify some "painful" measures (Shankarrao Chavan). However, the budget was not tough enough to stave off the crisis. In fact it announced a slew of debt reliefs for farmers, artisans and weavers, which only added to the liabilities of the government.

This begs the question, were bureaucrats in the economic ministries and cabinet ministers asleep at the wheel? They were certainly not unaware of the issue. Apart from the RBI, the IMF had also been raising concerns over the lack of fiscal adjustment from at least the middle of the 1980s. The Fund's medium-term debt **projections** for India as of 1988 (if the same spending path was to continue over the next five years), were off only by a few percentage points.

However since the government was not borrowing any longer from the IMF, the government ignored those admonishments without consequence. But warnings from the outside notwithstanding, the government itself had issued a white paper in 1985 that raised concerns over fiscal stability. The annual Economic Survey, prepared by a team at the ministry of finance, also repeatedly issued warnings during the decade.

The fact that by the time Manmohan Singh rose to present the budget in the summer of 1991 he was the seventh finance minister in six years did not help matters. But preserving institutional memory is one of the key reasons for having a professional bureaucracy, and therefore, the finance ministry cannot escape blame.

The government, perhaps, be could be been forgiven if one focused exclusively—and erroneously—on inflation to look for signs of fiscal excess. Friedman had famously noted that "Inflation is always and everywhere a monetary phenomenon..." and in India, it was the fiscal policy that drove the monetary growth.

Climbing down from the highs of the 1979-81 crisis, wholesale price inflation remained relatively subdued for the decade. The government, therefore, presumed that it had fiscal space. However, price rise had been kept in check by savage monetary measures that made credit inaccessible for everyone except the government and by keeping

administered prices low—almost a third of the components of the wholesale price index basket were either fully administered, partially administered or subjected to different forms of voluntary and other mechanisms. As would be expected, the result was undersupply and rationing of goods.

All the government had to do was to look at the debt figures. From 1980-81 to 1990-91, domestic public debt grew almost 40%, from 40% of GDP to 55%, while external **public debt** rose from 8.7% of GDP to 12.7%. While the latter figure may not look menacing in itself, in the context of an export sector that contributed less than 8% to GDP, it was quite alarming. With every conceivable agency having sounded the klaxon, continuing on the same path was nothing short of callous.

I.G. Patel, RBI governor from 1977 to 1982, describing the official reaction in a famous speech (http://www.jstor.org/stable/41498726), noted that "It was already clear by 1986 that we were in an internal debt trap which would soon engulf us in an external debt trap. Rather than take any remedial action, we went merrily along, borrowing more and more at home and on shorter and shorter terms abroad. The climate for official and concessional capital had turned irretrievably adverse for many years. But our response to that was not to strive harder for self-reliance but to increase the amount as well as the proportion of short-term debt in our total external indebted."

Vijay Joshi and I.M.D. Little (1994) **concluded** on the basis of interviews with those involved that "faulty analysis, lack of prudence, and weakness in the face of pressure" were responsible.

My own interviews of those in government at that time suggest that until the crisis struck in 1990, exhortations to prudence were dismissed as red herrings by the country's leadership. As long as growth was high and foreign creditors were willing to finance the deficit, no one was concerned about sustainability.

In public imagination, it was the global oil shock during the First Gulf War that caused the 1991 balance of payment crisis. But that was merely the trigger. By the end of 1980s, India was a child playing with matchsticks in a firecracker factory.