

**MANAGING EXTERNAL ECONOMIC
CHALLENGES IN THE NINETIES :
LESSONS FOR THE FUTURE**



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Summary of Discussion

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Discussants' Comments 1

S. Venkitaramanan

I deem it a privilege to chair this Seminar at Indian Council for Research on International

Challenges in the Nineties"- is one in which my friend Shankar's paper figures as

which he produces excellent papers, marked by an unsurpassed and difficult blend of lucidity and

every turn of the exposition , but ultimately ask,

that makes us marvel!

First, my compliments to the author, who was,

the nineties have, indeed, placed India at the top of

many economic storms and come through relatively unscathed. It is difficult even for a critic

design and implementation of India's economic

and national stresses, –
the political problems of India and the contagion of
the East Asian crisis.

coming years have been encapsulated in the paper

competitiveness of the Indian economy in an
increasingly integrated global environment.

laws, corporate governance, bankruptcy laws,
owne

scarce public resources towards valuable social
goods. Shankar calls special attention to the
challenges posed by the emerging new global
financial architecture. He cautions that progress
towards capital adequacy convertibility control has
to be carefully calibrated. No wonder, exchange
rate management will continue to be an art, as it
has been so far. Trade liberalisation is a challenge.
Lastly, Shankar cautions us about the possible
burst of the US bubble, which has now gone on for
nearly seven to eight years. He has, however,
nothing to say about the yuan or the yen – both
mysteries that may unravel suddenly!

At the outset, while I am one with Shankar in
complimenting the architecture of India's
economic reforms of 1991, I believe that we
should not forget that the much-abused evil
eighties were, in fact, the launching platform for
the nice nineties. It is invidious to judge the

eighties by the standards of the much more globally open nineties when flows in the private sector increased and financial markets expanded across the world. Let us not

started in India in the eighties. To be precise, one can even time it with the first national fiscal policy put forth by Shankar himself in a seminar work. We cannot also forget that

part, the rate of inflation remained, except for the year of drought notwithstanding high global - at around 6% and India's exports grew at

country's investment in infrastructure, such as power, railways, ports and telecom also expanded in the nineties. Whatever be the other reasons, in the

slowdown, because of the contraction of investment in the public sector. True, external

current account. But, there was no alternative

eighties other than debt, in the magnitudes that recent years have seen, especially with the

foreign direct investment into India. We cannot, at

gaps by non-

Emphasis has rightly been placed in the paper on the fact that short term debt has been strictly

controlled. Whether we like it or not, it is a matter of arithmetic that when gaps in current account of a country are met through capital flows in the nature of equity, there is an exchange of assets for liabilities. Whether or not we call it portfolio flows or FDI, liabilities of India taken as an economy increase to the extent that a foreign party invests in India. We owe that much more to the foreigner. While we may not have to pay interest, we do have to "pay" in the form of loss of control and dividends- if not capital appreciation. This is an elementary proposition, although it is not captured in the argument - and the perception - that debt service ratios are falling. Per contra, the commitment to "service" the equity is higher when equity flows finance the current account. It is the sum of the two that is important - the debt service and the equity service. I would, therefore, plead for a more balanced approach towards a debt-equity blend that is reasonable, rather than one overweighted in favour of foreign equity flows. Especially is this true since foreign portfolio flows can be fair weather friends and cannot be counted upon as too strong a pillar of policy. While I would go so far as not to put "sand" in the wheels of portfolio flows, as recommended by eminent economists abroad, I would argue that a balanced access to debt markets abroad makes more sense than over-dependence on equity, if we are to build an economy, controlled in the private sector by corporate headquarters in India and operating for the greater good of India.

Members of the audience here are sophisticated enough to realise that the crisis of 1990-91 was not so much a crisis of solvency as of liquidity. This is not a question of mere semantics. If the short-term liabilities of the State Bank of India, which came to nearly \$ 2bn. in 1991 had been converted to a medium or longer term loan, the "drama" of 90-91 would have been less sensational. It is, indeed, a fact that at about the height of the emerging Kuwait crisis in June 1999, a team of the SBI had waited on the mandarin in Delhi to be allowed to do this consolidation. It was a pity that both the foreign bankers, who had offered the conversion and the SBI team, were told, after weeks of waiting, that it was not necessary. It is also pertinent to note that late Shri Ram Malhotra, the then Governor of RBI had, as early as June-July 1990, warned Government of India that there was a looming danger inherent in the BOP situation and that action should be taken to preempt the crisis by approaching the IMF. More optimistic views, however, prevailed at the time in the Finance Ministry, perhaps for very good reasons. But, if action had been taken in time, there would have been less of a traumatic crisis. All that I wish to emphasise here is that there is a fallacy in the tendency to portray all that happened before 1990 as "sin" and that all was hunky-dory in the reforms thereafter.

What does the future hold? There is need to avoid the doctrinaire orthodoxies that have held - at least until recently - some of our policy makers

in thrall. There is no simple answer to the complex problems of macroeconomic management. I would like, however, to refer only to one aspect. India has been crucified on the monetarist paradigm, which makes expansion of credit a byproduct of decisions on the numbers that go to make up M(1), M(2) and M(3). While I do agree that fiscal irresponsibility has to be contained and money supply cannot grow without bounds, I would like to argue that the relationships sought to be established between M(3) and other variables have collapsed at least for the last few years. I recall in this connection the reported remark of Mr. Alan Greenspan, when asked about the behaviour of M(3). Half in joke, he seems to have said, "Are you referring the M(3) rifle?" I dare not tread on the preserve of statistical experts, who have tried to massage data to derive coherent relationships. Particularly, the relationship between the monetary variables of GDP and inflation has not been consistent. RBI has recognised this in its recent reports. Indeed, when the prices of onions or potatoes rose, it was not because of M(3), but because of policy on "supply". Supply side factors have been mainly responsible for the behaviour of price indices in the recent period. One hopes that the central banker does not rush to crush all incipient growth with a heavy hand, at the slightest hint of "inflation", which may be due to entirely different reasons.

Shortage of credit is the mirror image of monetary tightening. Unfortunately, as a result of the pursuit of the goal of lower inflation, regulatory purists have successfully purged the Indian economy of one source of credit, which small traders and industries used to get readily - "non-bank finance". With money centre banks catering increasingly to corporate and other high net-worth clients, the financial sector of India - especially in the the rural areas and middle towns - was dominated by the informal sector. Non-bank Finance Companies, which were spread all over, started filling the gap. True, there were black sheep amongst them and there was no deposit insurance or security for the depositors. Instead of trying to rectify this gap, the central bank and Government of India suddenly went into overdrive, literally stopping the flow of deposits as well as bank finance to even good NBFCs. Once the flow of funds was disrupted, NBFCs started to go into gridlock. They started calling in loans and this, in turn, affected other NBFCs. This disruption and consequent collapse of NBFCs led to many truck-owners, small industrialists and traders going bankrupt, in turn, affecting the banks themselves. Ultimately, the central bankers retracted some of their draconian regulations, but the damage had been done. The baby had been thrown out with the bathwater. Good, bad and indifferent, - all NBFCs were subjected more or less to the same treatment.

Non-bank finance having been disrupted, we are in a real credit crunch. Banks refuse - for obvious reasons of vigilance with a vengeance and other related factors - to take risks. Taking risks, even legitimate ones might do serious harm to lenders' careers. So much so, we are a unique case of an economy - in the whole of Asia - which has got the lowest ration of credit to GDP.

Let us note this important fact. Bank assets as percentage of GDP in India in 1998 were as low as 35.4%, while in China they were 120%, Korea 110%, in Taiwan 180%, in Japan 150%, in USA 60% (USA has a vibrant equity/debt market) and in Singapore 120%. Furthermore, in India, in the period 1995-98, there was a decline in overall financial assets from 1997 to 1991. Indeed, BIS shows credit to private sector decreased in real terms in the period. In tariffs and opening up of the economy drove Indian industry into a corner. This came on top of the reduction in public investment, in pursuit of the goal of deficit reduction. Apart from the loss of strength in infrastructure, it also drove the country into demand recession. It is undeniable that for an economy to grow, exports and domestic trade both require more easy access to credit, which is what is lacking in India. The paralysis of lending that is needed for successful career management is not going to unlock the key to the growth of India's economy.

In conclusion, let me reiterate that what I have said is not intended to diminish the considerable achievements of India's reforms. What I would like to stress is that in the process of emphasising certain aspects of reform, we may have given up many opportunities of growth. There is even today a great deal of strength in the Indian economy. We should not let dogma and doctrine deprive us of the prospects of further growth.