Financial crisis adds to India's turmoil

by Ramtanu Maitra and Susan B. Maitra

The assassination of former prime minister and Congress (I) Party president Rajiv Gandhi, which added to the increasing political violence in India centered around the tenth Lok Sabha (lower house of Parliament) elections, occurred at a time when the country's financial crisis, caused by a large foreign debt and a steadily rising domestic revenue deficit, had already made international bankers and financial institutions uneasy. The sale of 20 tons of gold by India in the last week of May in Zurich was, according to foreign sources, the result of the country's inability to attract foreign loans in the wake of the Gandhi assassination.

Whether or not that is strictly true, it is evident that India's foreign exchange crisis is growing by the day. Although the gold sale was actually a "gold swap," where India put up gold as collateral with the option of buying it back, there is no question that the move was a desperate step to avert default on debt repayments. Reportedly, the Reserve Bank of India (RBI), India's central bank, is considering various options to bolster foreign exchange reserves over the summer months, when India is expected to make close to $3.5 billion in debt repayments.

The options being considered include requesting the Basel-based Bank for International Settlements (BIS) to intervene on behalf of India with foreign commercial banks; raising money by using Indian-owned real estate abroad as collateral, such as property in Tokyo, which can fetch $500 million, and similar properties in New York, London, and other major cities; arranging for increased suppliers credit for oil purchases, which account for almost 40% of India's annual import payments in dollars; and requesting foreign airlines to defer remittances back to their respective countries.

Non-investment credit rating

If executed with success, these measures will give India a little breathing space—maybe as much as two to three months. Meanwhile, Standard and Poor's, one of the two leading U.S. credit-rating agencies, has further downrated India's credit rating, placing the country on the highest speculative or non-investment grade. The downgrading was announced only a day before the gold sale. Two other credit rating agencies, Moody's of the United States and the Japanese Bond Research Institute, had already placed India in the last investment grade. There is speculation that following the gold sale, these agencies will also put India in the non-investment category.

The foreign exchange crisis, which has already driven India to seek the help of the International Monetary Fund (IMF), stems from fast-rising foreign debt and increasing problems with the balance of payments. India's foreign debt stood at $18 billion in 1980. Today, according to the latest report of the World Bank, it exceeds $70 billion—a fourfold increase over the decade. Debt service, which was estimated at 8% of export earnings in 1980-81, is now estimated at almost 30%. The steep rise in foreign debt occurred during the period that Rajiv Gandhi was the prime minister (1984-89).

Gandhi had opted for increased foreign borrowing to step up economic growth. India's very high credit rating during these years encouraged the government and the corporate sector (public and private) to borrow heavily both through multilateral and bilateral channels as well as the commercial market. The import liberalization policy, announced in 1985, gave this trend a boost. A recent study of the 1985-87 period by the RBI, shows that the success of the Seventh Plan (1985-89) was largely due to the large-scale borrowing by the government from both home and abroad. That policy "made the industrial boom of the period possible and initiated the journey into the debt trap, according to the RBI."

On the positive side, it is indisputable that the borrowed money did some good. The Indian economy, which has shown an average growth rate of 3-3.5% for decades, registered a 5% annual growth rate over the 1980s. The high growth rates reduced poverty all around and decreased unemployment, as has been documented in several surveys published in 1990.

Debt crisis grows under National Front

Though the foreign exchange crisis had begun to surface in the last days of Rajiv Gandhi's prime ministership, it was made intractable by the National Front government that took over in November 1989. The V.P. Singh regime instituted a series of populist measures which grossly distorted the domestic financial situation, and virtually ignored the growing foreign exchange crisis and foreign economic affairs generally. The Gulf war made the situation worse. The additional cost of oil imports, decline in remittances from Indian workers based in the Persian Gulf, and the stagnation in exports added to the bleak situation.

To avert further erosion of foreign exchange reserves, the RBI announced a stringent import curb in mid-March of this year. The cuts, expected to last three to four months, imposed stiff cash margins to the tune of 133.33% on all raw materials imports. RBI has also made no allocation for capital

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goods imports, which means a virtual ban on these crucial imports, at least until these measures are lifted.

The RBI measures, hailed as necessary and also criticized for their severity, have directly affected the manufacturers of computers, consumer electronics, passenger cars, light commercial vehicles, and petrochemical products. It has also brought to a virtual standstill all new projects because of the stiff cash margin imposed on raw materials and virtual ban on import of capital goods. It is quite likely that the industrial production for 1991-92 will be adversely affected and the overall economic growth rate will drop noticeably. Should the monsoon play truant, causing significant damage to agricultural crops, the overall economic situation could become unmanageable.

Political stability key for the economy

At this writing the most important issue is whether the country will have a stable government following the general elections just completed. The IMF, which had provided India with a $1.8 billion loan last January, has made it clear that the additional $5 billion loan India is seeking is conditional on Delhi having a stable government. Finance Minister Yashwant Sinha has indicated that following his discussions with IMF Managing Director Michael Camdessus and World Bank President Barber Conable, India may be granted the loan by September.

Besides political stability, the IMF will certainly be demanding that India implement a series of measures before releasing the loans. In the latest edition of its "World Economic Outlook," the IMF charged India's policy implementation machinery with responsibility for the slowdown in economic growth. Among the conditions, the Fund is demanding that fiscal deficits be held to 6.5% of Gross Domestic Product by slashing subsidies, defense spending, and controlling money supply.

The recently leaked confidential report on India by the World Bank has given rise to apprehensions that the IMF will also demand reforms in the public sector and banking industry. The Bank has suggested a comprehensive macroeconomic adjustment program consisting of measures to enhance revenues and restrain expenditures in order to restore fiscal equilibrium and limit domestic demand. The report also called for tariff reductions for capital and intermediate goods because these sectors enjoy "higher protection."

Though there is general awareness that the Bank report, and what the IMF may suggest, is drawn strictly from the "free market" lexicon, there is hardly any disagreement among the political parties that India should lean on the International Monetary Fund to deal with the crisis. Despite general recognition of the threat posed to Indian sovereignty—at least in economic policymaking—Indian policymakers see no alternative. It is also generally understood that the debt problem will not ease in the near future, and may, in fact, get worse.

Currency Rates