The Indian economic reform process and the implications of the Southeast Asian crisis

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Foreword

This paper on the Indian reform process and the implications of the South-East Asian crisis gives an overview of the reform policies in India as well as an assessment of the impacts of these policies, especially in relation to employment and incomes. This assessment is then juxtaposed with the South-East Asian crisis in 1997-1999. The authors discuss to what extent the crisis in South-East Asia has an effect on the reform process in India, not only in terms of changes in the international markets (trade and capital) but also in terms of drawing lessons from the crisis in South-East Asia for the reform process in India. The authors conclude that it is necessary in order to understand the reform processes in India to unbundle the different elements of the economic reform process (liberalization, privatization, fiscal policy, monetary policy) and argue that in order for India to have a stronger and more sustainable development path, the reform process in India should be part of a wider set of economic and social policies including trade policies, industrial policies, and social policies. They conclude that a sound industrial policy is needed to increase the productivity in the Indian economic reform policy which should be applied in line with trade and investment policies. In order to arrive at a sustainable industrial policy a greater attention towards the social relations and the social policies at enterprise and at national level is needed. The authors argue therefore for a gradual process of liberalization and privatization, with the consent of all the stakeholders involved, in order to build up a solid industrial base from which India could build up a framework for better economic and social policy.

An earlier draft of this paper was prepared for the Tripartite Workshop on “Economic reform, employment and the role of labour market institutions: What challenges in the context of the current crisis in South East Asian countries” held in New Delhi on 21-27 May 1999 which was jointly organized by SAAT, New Delhi, the ILO Area Office, New Delhi and the Action Programme on Structural Adjustment, Employment and the Role of the Social Partners. It subsequently benefitted from observations by the participants at the workshop as well as from Ajit Ghose and Rolph van der Hoeven. The latter two were also involved in the formulation of the original terms of reference for the paper.

The Action Programme on Structural Adjustment, Employment and the Role of the Social Partners is intended to stimulate discussion on new generations of structural adjustment and reform policies which have to take into account the social aspects of reform policies and to contribute to increased capacity by social partners to be more effectively involved in the design, monitoring and evaluation of economic reform policies. It is managed by Rolph van der Hoeven.

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1. Introduction

The Southeast Asian economic crisis may have increased the employment of economists almost in proportion to the unemployment it has generated among workers in the region. Nevertheless, the still-unfolding crisis remains an area of controversy and confusion, in terms of the causes of the crisis and its implications, as well as the lessons for other developing countries. In this paper, we seek to unravel each of these issues with specific reference to the implications for the Indian process of "economic reform" instituted since 1991.

The paper begins with a discussion of the Indian structural adjustment package. The various features of stabilisation and structural adjustment are briefly highlighted. Specific policies relating to industry, agriculture, trade, exchange rates and the financial sector are also discussed. The second section provides an assessment of the effects of these policies, in terms of overall and sectoral output growth, export performance, fiscal patterns, poverty and unemployment and external vulnerability.

The third section is devoted to an analysis of the Southeast Asian crisis. The pattern of unfolding of the crisis is described, and the role of real economic factors (such as export deceleration) as well as financial factors is considered separately. The question of the factors behind the longevity of the crisis is also taken up here.

The fourth section deals with the ramifications of the Southeast Asian crisis for the world economy, in terms of the changing nature of investors' attitudes to emerging markets, international trade flows as well as enhanced financial fragility generally. The final section draws out some policy implications of this analysis for the Indian economy at the present conjuncture.

2. Synoptic overview of the current reform process

A process of creeping liberalisation had been launched by consecutive Indian governments had launched since the late 1970s, and especially after 1985. However, the current process of economic reform is dated from July 1991. In that year, following a balance of payments crisis generated by the withdrawal of international credit and non-resident Indian (NRI) deposits, India's foreign exchange reserves collapsed. The government opted for conditional credit from the International Monetary Fund to deal with the situation, necessitating policies of stabilisation, and an acceleration of 'structural reform' as well as its extension into the external and financial sectors. In what follows, we consider various aspects of this package.
2.1 Stabilization

In theory, stabilization required a sharp reduction in the fiscal deficit on the government's budget from its record high of 8.3 per cent of GDP in 1990-91 to a targeted 3-4 per cent of GDP over a short span of time. Towards this end, a major item of expenditure which was expected to be pruned was the outlay on subsidies, which accounted for 2.3 per cent of GDP at that point in time. In practice, however, public expenditure reduction has involved a substantial reduction in the outlay on capital formation, besides cuts in subsidies as well as certain other types of expenditure. While cuts in government capital expenditure are usually politically easier to enforce, they tend to be less desirable because they affect infrastructure provision and the potential for future growth.

In addition to these cuts, the process of stabilization required a sharp reduction in the "monetised deficit" of the government, or that part which was earlier financed through the issue of short-term, ad hoc Treasury Bills to the Reserve Bank of India, with the aim of giving the central bank a degree of autonomy and monetary policy a greater role in the economy. In a two stage process, involving initially a ceiling on the issue of Treasury Bills in any particular year, and subsequently the abolition of the practice of issuing Treasury Bills and substituting it with limited access to Ways and Means advances from the central bank for short periods of time, this aspect of stabilization has been more or less successfully implemented.

However, progress on reducing the fiscal deficit as a whole has been far short of target. The fiscal deficit which declined from 8.3 per cent to 5.7 per cent by 1992-93, rose sharply to 7.4 per cent in 1993-94. It has since remained above 6 per cent of GDP in three out of five years, and has never fallen below 5 per cent. Going by a comparable definition of the fiscal deficit, revised estimates for 1998-99 indicate that it has risen to 6.5 per cent of GDP.

The disconcerting feature of the fiscal deficit is not so much its level as the fact that a large proportion of it is due to a deficit on the revenue account of the government, rather than capital expenditure which would presumably lead to future growth. The revenue deficit, which stood at 3.5 per cent of GDP in 1990-91, peaked at 4.0 per cent in 1993-94 and has remained well above 3 per cent in most subsequent years. This implies that the government has had to borrow large sums to finance even its current expenditure. With access to credit in the form of low interest Treasury bills having been closed as a result of the financial liberalisation agenda, the government has had to borrow at relatively high interest rates from the open market, substantially increasing the interest burden on the budget. Interest payments by the government as a percentage of GDP have risen from 4 to 4.8 per cent between 1990-91 and 1998-99. The government has also not been too successful in curbing revenue expenditures on heads other than interest and subsidies. Such expenditures fell from a high of 7.5 per cent of GDP in 1990-91 to 6.5 per cent in 1996-97 before rising again to 6.9 per cent in 1997-98.

This has occurred at a time when the ratio of central taxes to GDP have fallen because of (i) a loss of customs revenues as a result of tariff-reducing trade liberalisation; (ii) reductions in excise duties aimed at triggering a consumer boom; (iii) cuts in direct taxes, partly aimed at providing

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1 The subsidies referred to here are the direct budgetary outlays on consumer subsidies such as the food and fertiliser subsidies, rather than the indirect subsidies and producer subsidies which are determined by public sector pricing and other factors.
incentives to save and invest, and partly at raising revenues, based on a misplaced belief in the Laffer curve; and more recently (iv) an industrial recession that has affected tax collections adversely. As a result of these various processes, the tax-GDP ratio fell quite significantly over the years of economic reform, from close to 11 per cent of GDP to 9.3 per cent in 1997-98.

This has meant that even to constrain the fiscal deficit at existing levels, expenditures have had to be restrained largely through cuts in subsidies and capital expenditures. Subsidies, which accounted for 2.3 per cent of GDP in 1990-91 fell to 1.3 per cent in 1996-97 and remained at that level in 1998-99. The budget for 1999-2000 expects them to fall to 0.9 per cent of GDP as a result of recent increases in the prices of food issued though the public distribution system to the population above the poverty line. And capital expenditure, which fell from 5.9 per cent of GDP in 1990-91 to 3.7 per cent by 1997-98, have risen only marginally to 4 per cent in 1998-99.

There are few who disagree that the decline in capital expenditure needs to be reversed. As the recently prepared Ninth Plan document makes clear, there has been a huge short fall in public investment relative to targets during the Eighth Plan period (1992-97). This shortfall has been most evident in crucial sectors such as agriculture and rural development, industry and minerals. The ratio of public investment to GDP stood at 8.3 per cent as compared with a target of 10.4 per cent. The effects of this shortfall, it is admitted, have fallen "disproportionately on economic and social infrastructure", with adverse consequences for growth and human development.

### 2.2 Structural adjustment

The principal aims of the structural adjustment policies adopted as a part of the reform process were: (i) to do away with or substantially reduce controls on capacity creation, production and prices, and let market forces influence the investment and operational decisions of domestic and foreign economic agents within the domestic tariff area; (ii) to allow international competition and therefore international relative prices to influence the decisions of these agents; (iii) to reduce the presence of state agencies in production and trade, except in areas where market failure necessitates state entry; and (iv) to liberalise the financial sector by reducing controls on the banking system, allowing for the proliferation of financial institutions and instruments and permitting foreign entry into the financial sector. In what follows, we consider policies specific to the various sectors.

### 2.3 Industrial policy

Post-reform industrial policy has moved in three principal directions. The first was the removal of capacity controls by "dereserving" and "delicencing" industries, or abolishing the requirement to obtain a licence to create new capacity or substantially expand existing capacity. As a result of the dereservation of areas earlier reserved for the public sector and the successive delicencing of industries, there were only nine industries for which entry by private investors was regulated at the end of 1997-98.

The second area of industrial reform related to the dilution of provisions of the MRTP Act, so as to facilitate the expansion and diversification of large firms or firms belonging to the big business groups. Prior to 1991, all firms and interconnected undertakings with assets above a certain size, pegged at Rs. 100 crore in 1985, had been classified as MRTP units. These firms required separate approvals, besides obtaining an industrial licence, to undertake new investments. The MRTP
Amendment Bill removed the threshold limits with regard to assets for defining MRTP or dominant undertakings, thereby removing any special controls on large firms.

The third type of liberalisation in industry involved foreign investment regulation. The first step in this direction was the grant of automatic approval, or exemption from case by case approval, for equity investment of up to 51 per cent and for foreign technology agreements in identified high-priority industries so long as royalty does not exceed 5 per cent of domestic sales (8 per cent of export sales) and lump-sum technical fees do not exceed Rs. 1 crore. As a follow up, the Foreign Exchange Regulation Act was modified so that companies with foreign equity exceeding 40 per of the total were also to be treated on par with India companies. Further, Non-Resident Indians and overseas corporate bodies owned by them were permitted to invest up to 100 per cent equity in high priority industries, with repatriability of capital and income. Foreign investors were also allowed to use their trade marks in Indian markets. Even in cases which went before the newly created Foreign Investment Promotion Board, the government was liberal in approving proposals and providing a high equity share to foreign investors going up to 100 per cent in many cases. More recently automatic approval has been allowed even for cases involving foreign equity in excess of 51 per cent. The latest Budget for 1999-2000 proposes that this be extended, for example, to the pharmaceutical industry, and also allows a range of concession in Indian markets. Even in cases which went before the newly created Foreign Investment Promotion Board, the government was liberal in approving proposals and providing a high equity share to foreign investors going up to 100 per cent in many cases. More recently automatic approval has been allowed even for cases involving foreign equity in excess of 51 per cent. The latest Budget for 1999-2000 proposes that this be extended, for example, to the pharmaceutical industry, and also allows a range of concession to accelerated industrial growth. The actual effects are discussed below; however, it is briefly mentioned that after an initial spurt led by an import-led consumer boom, growth rates have slumped once again and manufacturing industry has been in recession since mid-1996. This suggests that liberalisation per se in not enough and that other strategies may be necessary to encourage the "animal spirits" of entrepreneurs.

2.4 Trade liberalisation

The major policy shift contributing to heightening competition was the liberalisation of the import trade. A distinguishing feature of the economic reforms of the 1990s was the effort to dilute import controls by rapidly reducing the number of tariff items subject to quantitative restrictions, licensing and other forms of discretionary controls on imports as well as by cutting the rates of tariff on a range of commodities. By the middle of 1998 there were 7117 items that could be imported freely under the Open General Licence Scheme. As on 1 April 1997, there were residual import restrictions for balance of payments purposes on 2,714 tariff lines at the eight-digit level of the Indian Trade Classification. These are to be abolished in three phases by April 1, 2003. The peak tariff rate has fallen from as high as 300 per cent or more to 40 per cent currently.

However, the process of tariff reduction has not been uniform across industrial sectors. Imports of capital goods have been substantially liberalised by placing them under the OGL category, by reducing tariffs and by offering concessional duties for "project imports" and imports allowed at zero duty subject to promises of exports to be realised (as in the case of the Export Promotion
Capital Goods import scheme). The same is true of imports of intermediates, access to which have been simplified and subjected to lower duties.

In the case of consumer goods, until recently the government was more cautious, especially with regard to duty reduction. This was justified by revenue considerations and with arguments regarding "non-essentiality". However, recently, in the two annual Export-Import Policies presented by the BJP-led government for 1998-99 and 1999-2000, there has been fairly wide-ranging liberalisation of the import of consumer goods which have been placed on the OGL list, so that currently very few items remain on the negative list for imports.

The differential protection offered to different categories of commodities combined with easier entry for both domestic and foreign firms meant that there was a spurt in production of a number of new consumer goods based on imports of capital, technology and intermediates from abroad. In most cases that spurt has been based on foreign investment by internationally renowned firms which are now free to use their brand names in the domestic market. Given the pent-up demand for new product innovation, especially those carrying international brand names, among a section of well-to-do consumers, there existed a ready, once-for-all market for such commodities. As a result, after a brief period when industrial growth slowed because of the recessionary consequences of increased import competition and stabilization-induced cuts in government expenditure, India's industrial sector witnessed a boom based on rapid growth in the automobiles and consumer goods sectors, especially consumer durable goods. But when the once-for-all market provided by the pent-up demand for such commodities was exhausted, growth slowed down once again, pushing the industrial sector into a recession.

2.5 Reforms in agriculture

The economic reforms did not include any specific package for agriculture. Rather, the presumption was that freeing agricultural markets and liberalising external trade in agricultural commodities would provide price incentives leading to enhanced investment and output in that sector. However, the pattern of structural adjustment and the government's macro-economic strategy since 1991 have actually been associated with a reduced rate of overall agricultural growth, declines in per capital foodgrain output and inadequate employment generation.

The post reform strategy involved the following measures which specifically related to the rural areas:

(1) Actual declines in Central government revenue expenditure on rural development (including agricultural programmes and rural employment and anti-poverty schemes), as well as on the fertiliser subsidy, in the budgets of 1991-92 and 1992-93 and 1998-99. Some of these cuts, such as that on the fertiliser subsidy, were partially reversed subsequently, but the overall decline in per capita government expenditure on rural areas has remained.

(2) Very substantial declines in public infrastructure and energy investments which affect the rural areas. These have not related only to matters like irrigation but also to transport which indirectly contributes significantly to agricultural growth and productivity through its linkage effects, besides being an important source of rural employment.
(3) Reduced transfers to state governments which have been facing a major financial crunch and have therefore been forced to cut back their own spending, particularly on social expenditure such as on education and on health and sanitation. Quite apart from their welfare implications, these provided an important source of public employment over the 1980s.

(4) Reduced spread and rising prices of the public distribution system for food. This had a very important effect on rural household food consumption in some areas of the country.

(5) Financial liberalisation measures, including reducing priority sector lending by banks, which have effectively reduced the availability of rural credit, and thus reduced farm investment, especially by smaller farmers.

(6) Liberalisation of trade in agricultural commodities, both across states within India and external trade. Thus, restrictions on the inter-state movement of agricultural commodities have been virtually removed. Imports of a range of agricultural commodities have been shifted from quota controls to tariffs and these tariffs have been very substantially lowered over the 1990s. Exports of important cultivated items, especially rice, have been freed from controls, leading to increased exports of these commodities. These have led to declines in the relative price of importables such as edible oils, and increases in the relative price of exportables such as rice and cotton.

The proponents of policies such as trade liberalisation, agricultural export promotion and the reduction of per capita food subsidies, have argued that they would necessarily lead to an acceleration of output growth in agriculture by increasing market-based incentives for agricultural investment and output. But such an acceleration has not occurred, and indeed agricultural growth has decelerated in the 1990s compared to the earlier decade, as discussed in more detail below.

2.6 Exchange rate policy

Along with policies directly or indirectly affecting the "real" commodity producing sectors, the reform process has been directed at the financial realm as well. To start with, in a series of steps the government has moved to a situation where there is a unified, market determined exchange rate of the rupee, which is fully convertible for current account transactions. In addition, various financial liberalisation measures which are discussed below have had direct and indirect implications for exchange rate management, since they affect the inflow and outflow of short-term capital into the country.

Until the crisis in Southeast Asia, the government appeared keen on moving to full convertibility of the rupee. The official Tarapore Committee set up to draw up a road map for the process had recommended that the implementation be spread over 1997-98 to 1999-2000 and suggested preconditions to be met sequentially for this. Besides fiscal consolidation, a mandated inflation target and the restructuring of bank capital, the road-map prescribed a stepwise process of financial liberalisation. However, the East Asian crisis put plans for a rapid transition to capital account convertibility on hold for a time, and the capital account of the balance of payments still continues to be governed by a range of restrictions, even though several others have already been lifted.
2.7 Financial liberalisation

An important area where major reforms have been continuously implemented is in the financial sector. The process started with the repeal of the Capital Issues (Control) Act, 1947 and the abolition of the Controller of Capital Issues. Companies could freely seek finance through the capital market, subject to the regulations of the newly created Securities and Exchange Board of India (SEBI). Indian companies were allowed to access international capital markets through Euro-equity shares. A range of non-bank financial companies, including private mutual funds were allowed to operate. Investment norms for NRIs were liberalised and Foreign Institutional Investors (FIIs) were allowed to register and invest in India's stock markets, subject to an overall ceiling (30 per cent) and a ceiling for each individual FII in a particular company's shareholding. In addition, the government did away with the higher rate of capital gains taxation which applied on foreign and NRI investment that chose to invest in the stock market and leave in a short period of time. Besides these, a number of guidelines to ensure transparency in share issues were specified.

The other element in financial sector reform was that regulation of the banking sector in terms of controls on entry by private domestic and foreign players, Cash Reserve Ratios and Statutory Liquidity Ratios, entry of financial institutions into the banking sector, priority sector credit provision and investments and activities, have been substantially eased. A range of new instruments have also been permitted.

In the initial post-reform period, stabilization measures such as a tight control over money supply and restraints on central bank credit to the government, which forced it to mobilise resources from the open market resulted in a sharp rise in interest rates. This was particular true during the years of boom driven by the pent-up demand for consumer goods. This, of course, helped sustain inflows of foreign and non-resident capital in search of high returns. But it also adversely affected private investment and aggravated the recession generated by the curtailment of government expenditure, once pent-up demand was satiated. Subsequently, even though the increase in liquidity resulting from financial liberalization helped the central bank bring down interest rates, the recession still persisted. In addition, the rise in interest rates has substantially increased the interest burden of the government. As a consequence, interest payments accounted for 27 per cent of total expenditure and 44 per cent of revenue expenditure of the Central Government in 1998-99.

Overall, one of the consequences of financial sector reform was India's growing dependence on volatile short-term flows of capital in the form of FII and NRI investments and NRI deposits. Combined with the decision to allow the value of the rupee to be determined by market forces, which made central bank purchases and sales of foreign exchange the only means by which the government could influence the value of the rupee, this resulted in considerable uncertainty regarding the value of the rupee. Further, domestic policies with regard to expenditure, interest rates and exchange rates were now influenced by perceptions of how it would affect whimsical foreign investor sentiment. This has substantially reduced the manoeuvrability of the government, and made it difficult for it to change policy track, if and when it chooses to, in order to deal with many of the problems that have emerged during the period of reform.
3. An assessment of the impact of India's structural adjustment

3.1 Growth rates

The first notable consequence of structural adjustment has been a slowdown in the average rate of growth of the economy relative to the preceding quinquennium, as evident from Table 1.

Table 1: Average annual growth rates (1980-81 prices)

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<th></th>
<th>GDP</th>
<th>Agriculture</th>
<th>Industry</th>
<th>Services</th>
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<tbody>
<tr>
<td>Average VII Plan (1985-90)</td>
<td>6</td>
<td>3.4</td>
<td>7.5</td>
<td>7.4</td>
</tr>
<tr>
<td>1990-91 to 1997-98</td>
<td>5.6</td>
<td>2</td>
<td>6</td>
<td>7</td>
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Source: Calculated from the Economic Survey 1998-99, GOI.

It has been argued that Fund-Bank style reforms are inevitably associated with deflation in the short-run, and it is only after a while that the economy is expected to pick up on the basis of stimuli other than those which prevailed under the earlier regime. In short, a transitional period of stagnation is expected, and should not cause undue worry, since growth would subsequently pick up on a new and supposedly more secure basis. In the case of India too, until recently it appeared that there were two distinct phases of growth in the post-reform period, a phase of deflation during which the economy was being sought to be stabilised, and a subsequent phase of recovery, starting from 1993-4.

It is now clear, however, that this recovery was a result of transient phenomena. These included the stepping up of the fiscal deficit in 1993-94, and, even after the fiscal deficit had been lowered in the subsequent years, the satisfaction of pent-up demand for a variety of hitherto-not-available luxury consumer goods. Since the rate of growth of the demand for such goods, as opposed to the once-for-all splurge that the satisfaction of pent-up demand entails, is much lower, the stimulus which such demand imparts to industrial production evaporates quickly; and this is exactly what has happened.

Industrial performance has been dismal in 1997-98 and 1998-99 (Table 2). As a result, compared to an average annual growth rate of 8.4 percent in the index of industrial production (which is distinct from real value added in industry) during the quinquennium 1985-86 to 1990-91, the rate for the eight years 1991-92 to 1998-99 (on the assumption that the growth rate observed during April-December of 1998-99 holds for the year as a whole) comes to 5.7 per cent.

This slowing down clearly is a secular phenomenon, not just a short-term consequence of stabilization. It is an expression of the loss of expansionary stimulus that a ‘liberalised’ economy entails, through the decline of public investment, through higher interest rates, and through the shrinkage of demand owing to import liberalization.
Table 2: Industrial growth rate (percentages)

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<tbody>
<tr>
<td></td>
<td>0.66</td>
<td>2.39</td>
<td>5.93</td>
<td>8.4</td>
<td>5.56</td>
<td>6.58</td>
<td>3.5</td>
<td></td>
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</table>

Note: New series with base 1993-94 = 100.

A slowdown is also evident in the agricultural sector, where the growth rate in the production of foodgrain in particular has declined sharply. For a long time now the Indian economy has experienced a secular growth rate of foodgrain production of around 2.5 percent per annum which was a little higher than the population growth rate. Even during the 12 year period 1978-9 to 1990-1 (both being good agricultural years are comparable), the rate of growth of foodgrain production was 2.4 percent which was above the population growth rate.

However, over the period 1990-1 to 1997-8 (again both good agricultural years), the growth rate of foodgrain production dropped to 1.2 percent which was distinctly lower than the population growth rate. This is the lowest average rate since the mid-1950s, and a very dramatic drop compared to the earlier decades. In such a context, increased volumes of exports (both foodgrain and cash crop) along with higher rupee prices of such exports because of rupee devaluation, have also meant rapidly rising prices of food in the domestic market. Further, the period of the 1990s, besides exhibiting the usual fluctuating pattern in agricultural output, is marked by two years of substantial decline in the relatively recent past.

What is interesting is that neither of these two years - 1995-96 and 1997-98 - was considered to be a particularly bad year in terms of aggregate rainfall and weather conditions. It is also worth noting that in the three years of negative growth over this period, value-added has fallen even more sharply than production, and this has occurred despite the general tendency of agricultural prices to move faster than the general price index.

We are therefore witnessing the emergence of a process which could culminate in a serious food crisis. The fact that despite this reduction in output growth rate there has been no actual food shortage till now is little consolation. It merely shows that purchasing power among the workers, especially the rural workers, has increased even more slowly in real terms (i.e. when deflated by an index of the administered prices of foodgrain). The reason for this lies partly in the steep escalation in administered prices of food which occurred in the aftermath of ‘structural adjustment’ as a part of the so-called fiscal correction (for which subsidies had to be kept down), and partly in the shift of emphasis towards export agriculture and away from food crops. Foodgrain production being more employment-intensive than the exportable commodities which substitute for it in terms of land use, such as prawn fisheries, sunflower, orchards etc., a shift of acreage from the former to the latter that occurs as a sequel to ‘liberalization’ has the effect of restricting employment growth. In fact this
latter process explains *inter alia* both the decline in foodgrain output growth and some of the decline in employment elasticity of output.

Given the size of India’s population, the large incidence of absolute poverty and the continuing agrarian nature of the bulk of the work force, such trends have extremely dire implications. They suggest that the issue of domestic food security is not just a continuing problem but may even become a potentially explosive one. Thus, in the nineties, several of the public policies which contributed to more employment and less poverty in the rural areas in the earlier decade have been reversed.

There is however an additional factor behind the drop in foodgrain output growth. This is the drastic decline in real public investment that has occurred in agriculture over a long period. Gross capital formation (at 1980-81 prices) under the aegis of the government in the agricultural sector was Rs. 17960 m. in 1980-81; it remained way below that level throughout the 1990s, reaching Rs. 11540 m. in 1990-91 and only Rs. 13100 m. in 1995-96. The deceleration had occurred during the 1980s itself, but the 1990s have done nothing to boost public investment. During the 1990s there has no doubt been a step up in real private gross capital formation in this sector from Rs. 34400 m. in 1990-91 to Rs. 49910 m. in 1995-6. But much of the increase in private investment is likely to have been in the non-traditional sectors of export agriculture rather than in foodgrain production. It is noteworthy that the growth rate between 1990-91 and 1996-97 shows a sharp decline not only for the coarse grains from which much land has shifted towards export crops like sunflower, but even for rice (1.52 percent compared to 3.35 percent for 1980-81 to 1995-96). This is symptomatic of a decline in investment in traditional food crops.

In addition, there has been an initial decline and a subsequent overall stagnation of the investment ratio, as indicated in Table 3.

### Table 3: GDCF as percentage of GDP

<table>
<thead>
<tr>
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<th>1990-1</th>
<th>1994-5</th>
<th>1999-94</th>
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<tbody>
<tr>
<td>1990-1</td>
<td>27.7</td>
<td>25.4</td>
<td>22.4</td>
</tr>
<tr>
<td>1991-2</td>
<td>23.4</td>
<td>25.8</td>
<td>1995-6</td>
</tr>
<tr>
<td>1992-3</td>
<td>23.9</td>
<td>25.7</td>
<td>1996-7(P)</td>
</tr>
<tr>
<td>1993-94</td>
<td>22.4</td>
<td>24.8</td>
<td>1997-8 (QE)</td>
</tr>
</tbody>
</table>

Note: Figures up to 1992-93 are based on old series (Base 1980-81) and from 1993-94 based on new series (Base 1993-94). P = Provisional; QE = Quick estimates.


But even these figures represent overestimates. The method of estimating capital formation is such that in a period of growing consumerism involving import-intensive durable goods and 'capital goods' like automobiles in the post-liberalization period, the tendency invariably is for an
overestimation of investment. It goes without saying that if the actual investment ratio, far from increasing, has been either stagnant or declining, then the acceleration in growth-rate promised by the reforms would not materialise.

This sluggish investment performance is not surprising. The proposition underlying the economic reform policies that if only more surpluses are handed over to private operators they would automatically invest more, is a presumption based on the erroneous belief that there can never be a demand constraint in a market-based system. In fact, private agents invest in response to specific stimuli. In the pre-liberalization regime the main stimulus came, directly or indirectly, from public investment and expenditure in general. This had a "crowding in" rather than a "crowding out" effect on private investment. A "liberalised" economy however entails a loss of this stimulus, compounded by other factors such as high interest rates and loss of domestic markets through liberal imports, which is not offset by any corresponding new stimulus.

3.2 Exports

Of course, exports can constitute such a new stimulus and indeed it is frequently argued even today that whenever the domestic market falls short then producers can export their way out of any problems. However, one of the failures of structural adjustment in India has been its inability to stimulate India's exports. After an extremely poor performance in 1991-92 and 1992-93, India's exports (in dollar terms) appeared to gain momentum, growing at an average rate of close to 20 per cent during the three years starting 1993-94. However, exports slumped from 1996-97, with the rate of growth touching 5.6 per cent (Table 4).

Exports by all the major groups of products - agricultural, mineral, and manufactured goods - have declined. Exports of agricultural and allied products have been declining now for the past two years. The performance of manufactured goods exports has been even more dismal. In 1997-98 such exports had increased by 8 per cent, but in the period April-September 1998 they declined by 7 per cent compared to the previous year. This category includes many items which had been part of the government’s “thrust sectors” for export, such as textiles, leather goods, machinery and transport equipment, electronic goods, and so on, all of which showed lower exports. Even ready made garments, which had been the great mainstay of the previous year's manufactured exports, have showed a relatively low increase.

Some of this slump can of course be attributed to the deceleration in world export growth and an appreciation of the rupee in real terms. However, this is at best a partial explanation and it is clear that other factors, some of them domestic, must have been responsible as well. There have been some other countries - notably the Philippines - which have been able to weather the deceleration in world export growth, and register creditable export growth rates even when many East Asian countries were faring poorly. Similarly it must be remembered that the real appreciation of the rupee was partly because of the large inflows of capital into the country in the wake of financial liberalization. In the recent period, as well as in the 1990s overall, Indian exports have performed much worse than world exports, and India’s share of total world trade has fallen.

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2This is explained in detail in Chandrasekhar, 1996
It is true that the dramatic depreciation of several of the currencies of the Southeast Asian region has affected Indian export competitiveness in a number of competing sectors such as textiles, garments, leather and electronic goods. Also, the now generalised economic depression in the Southeast Asian region has definitely had an impact on Indian exports to that region. Exports to Asia have fallen by 25 per cent over the period 1996-98. The trend is even stronger if the Southeast Asian countries alone are considered, with huge declines in Indian exports to Philippines (64 per cent). The Republic of Korea (60 per cent) Malaysia (45 per cent) Taiwan, China (29 per cent) and Thailand (19 per cent).

But the very facts that even under such circumstances, exports to the United States have gone up by nearly 10 per cent, and that those to Europe have crashed even though they are mostly in items that not directly competitive with Southeast Asia, suggests that there must be other factors at work. Insofar as these factors are internal to the Indian economy, it is important to address them immediately. And if they reflect the nature of the interaction between India and the world economy, then it may be necessary to rethink the terms of such interaction.

This argument may become clearer if we consider the processes that have been released by trade liberalization and global economic trends in terms of domestic relative prices and incentives for producers. One of the important implications of the liberalization of agricultural trade in India in the nineties has been the increased possibility of crop exports. This in turn has meant that Indian food prices (which in general were below international prices) have come closer to the international standard. Indeed, food price inflation has become the defining feature of price movements in the country in the past few years. Meanwhile, the liberalization of imports has also suppressed rises in the prices of many manufactured goods which are affected by import competition.

In this context, the rise in food prices has an interesting implication, quite apart from whether or not they improve material standards for the country’s farmers. They certainly lead to pressures for nominal wages to increase. And it is clear that this has occurred, although in most states this has not been enough to counterbalance the effect of higher food prices, so that real wages have fallen.

However, even though real wages have fallen, product wages are likely to have risen in most non-food producing sectors, for the simple reason that inflation in these sectors has been less marked. This actually squeezes the profitability of producers in non-food sectors, and can also make them less competitive. Such a combination, of falling real wages and rising product wages in the manufacturing sector, would also create a certain pattern of incentives for producers, discouraging productive investment in these sectors. This could certainly form part of the explanation of both domestic industrial stagnation and poor performance in manufactured exports.

Thus the manner in which the process of economic liberalization has unfolded in India thus far suggests that, while it has failed to deliver its promised benefit of a foothold in world markets, it may have actually been working against the acceleration of export growth.
Table 4: India's trade performance

<table>
<thead>
<tr>
<th>Year</th>
<th>Exports Growth rate (%)</th>
<th>Imports Growth rate (%)</th>
<th>Trade Def/GDP (%)</th>
<th>Cur Acct Def/GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991-92</td>
<td>-1.1</td>
<td>-24.5</td>
<td>1</td>
<td>0.3</td>
</tr>
<tr>
<td>1992-93</td>
<td>3.3</td>
<td>15.4</td>
<td>2.2</td>
<td>1.7</td>
</tr>
<tr>
<td>1993-94</td>
<td>20.2</td>
<td>10</td>
<td>1.5</td>
<td>0.4</td>
</tr>
<tr>
<td>1994-95</td>
<td>18.4</td>
<td>34.3</td>
<td>2.7</td>
<td>1</td>
</tr>
<tr>
<td>1995-96</td>
<td>20.3</td>
<td>21.6</td>
<td>3.1</td>
<td>1.6</td>
</tr>
<tr>
<td>1996-97</td>
<td>5.6</td>
<td>12.1</td>
<td>3.7</td>
<td>1.1</td>
</tr>
<tr>
<td>1997-98</td>
<td>2.1</td>
<td>4.4</td>
<td>3.9</td>
<td>1.6</td>
</tr>
<tr>
<td>1998-99</td>
<td>-2</td>
<td>5</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

This was not initially so much of a problem because low world oil prices resulted in a fall in India's oil import bill and the industrial recession slowed the rate of growth of non-oil imports. More recently however imports are once again rising fast enough to more than neutralise the benefit of low oil prices, resulting in a rise in the trade deficit. The export competition from East Asia where currencies have depreciated massively, has accentuated this problem. As a result, despite large inflows of remittances from non-resident Indians, the current account deficit has been rising. If the East Asian experience is indicative, this can become an important basis for a weakening of investor confidence.

### 3.3 Fiscal patterns

The usual justification for ‘rolling back’ the State is that the fiscal deficit must be cut, since it is a source of instability of the economy. Not only is this argument questionable, but, what is more, this package tends to intensify the fiscal crisis.

There is an important distinction to be made here. In an economy that is liberalised with respect to the capital account of the balance of payments, and hence open to speculative capital flows, it may well be the case that speculators look at the size of the fiscal deficit which thus becomes a determinant of their state of confidence (so that denouncing fiscal deficits becomes a self-fulfilling prophecy in a liberalised economy), but this is different from saying that the fiscal deficit *per se* is destabilising. The latter argument is untenable for several reasons.

First, the size of the fiscal deficit, which shows the net demand arising from the government, does not have anything to do directly with ‘instability’ in the sense of either generalised inflationary pressures or an unmanageable trade deficit, since the latter depend upon *ex ante* excess aggregate demand. Secondly, while borrowing to meet current expenditures does require scrutiny (though it is not always reprehensible, for example in a recession) since it is indicative of "living beyond one's means", there is nothing necessarily wrong with borrowing to
meet investment requirements. If the focus was on a reduction of the revenue deficit, then it might make sense, but by emphasising the fiscal deficit as distinct from the revenue deficit, the IMF and the World Bank deliberately try to negate the role of the government as an investor. Thirdly, a reduction in the revenue deficit, or in the fiscal deficit, can be brought about in a number of different ways, the obvious one being an increase in direct tax revenue. Indeed in any developing economy where glaring poverty coexists with offensive opulence, increased revenue from direct taxes is urgently called for anyway as a means of reducing inequalities. But policies of liberalization or the new-style economic reforms invariably underplay this avenue of deficit reduction and emphasise cuts in investment and welfare expenditures.

Not only is the theory underlying such cuts invalid, but the fiscal deficit which is invoked to legitimise such cuts gets aggravated because of 'structural adjustment'. Since inviting direct foreign investment becomes an overriding objective of economic policy, the rates at which they are taxed gets reduced in competition with other countries. This, for reasons of symmetry, means that direct tax rates on the rich as a whole are lowered. Since customs duties are cut as part of the import liberalization package, and excise duties, again for reasons of symmetry, cannot be raised as a consequence, indirect tax revenues too suffer. This is aggravated by the sluggishness in output growth rate that cuts in government expenditure may engender.

While tax revenues cannot be raised for lowering budget deficits, the increased interest rates, resulting in a larger interest burden on the government, which are another legacy of structural adjustment, add to the expenditure side. Increased interest rates on public sector borrowing are typical results of the financial liberalization process which was discussed above. Two features are particularly significant in this process: first, the removal of interest rate caps and other such restrictions in the credit market, which allow all interest rates to go up; and the raising of norms on the Statutory Liquidity Ratios and other such compulsory holding of government securities, which force the government to take recourse to open market borrowing to finance deficits.

Thus this type of structural adjustment, which aims to restrict the fiscal profligacy of the State, contains within itself processes which work to aggravate further the fiscal situation, through lower taxes on the rich and higher interest rates.

The Indian experience described in Table 5 fully bears this out. Not surprisingly, the fiscal adjustment in India has left the size of the revenue deficit unchanged or even enlarged, and instead impinged heavily on public investment and welfare expenditure. The process of adjustment has further entailed a very specific fiscal regime, which has increased transfers from the State to rentiers in the form of interest payments, and to enforce larger fiscal burdens on the people and cuts in public investment.
Table 5: Some fiscal magnitudes as ratios of GDP

<table>
<thead>
<tr>
<th></th>
<th>Revenue Deficit</th>
<th>Fiscal Deficit</th>
<th>Interest</th>
<th>Subsidies</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988-89</td>
<td>2.7</td>
<td>7.8</td>
<td>4</td>
<td>2.2</td>
</tr>
<tr>
<td>1989-90</td>
<td>2.6</td>
<td>7.8</td>
<td>4.3</td>
<td>2.6</td>
</tr>
<tr>
<td>1990-91</td>
<td>3.5</td>
<td>8.3</td>
<td>4</td>
<td>2.5</td>
</tr>
<tr>
<td>1991-92</td>
<td>2.6</td>
<td>5.9</td>
<td>4.3</td>
<td>2.2</td>
</tr>
<tr>
<td>1992-93</td>
<td>2.6</td>
<td>5.7</td>
<td>4.5</td>
<td>1.9</td>
</tr>
<tr>
<td>1993-94</td>
<td>4</td>
<td>7.4</td>
<td>4.5</td>
<td>1.6</td>
</tr>
<tr>
<td>1994-95</td>
<td>3.2</td>
<td>6.0</td>
<td>4.6</td>
<td>1.3</td>
</tr>
<tr>
<td>1995-96</td>
<td>2.7</td>
<td>5.4</td>
<td>4.5</td>
<td>1.2</td>
</tr>
<tr>
<td>1996-97</td>
<td>2.6</td>
<td>5.2</td>
<td>4.6</td>
<td>1.3</td>
</tr>
<tr>
<td>1997-98</td>
<td>3.3</td>
<td>6.3</td>
<td>4.7</td>
<td>1.4</td>
</tr>
<tr>
<td>1998-1999</td>
<td>3.8</td>
<td>6.5</td>
<td>4.8</td>
<td>1.3</td>
</tr>
<tr>
<td>1999-2000*</td>
<td>2.3</td>
<td>4.4</td>
<td>3.7</td>
<td>0.9</td>
</tr>
</tbody>
</table>

Notes:  * refers to Budget estimates
- Revenue deficit refers to current expenditure minus current revenue
- Fiscal deficit refers to all expenditure minus current revenue, that is revenue deficit plus capital expenditure
- Interest refers to all interest payments of the government
- Subsidies refers to all direct budgetary allocations for subsidies, i.e. Food and Fertiliser subsidies


3.4 Poverty and employment
The fourth significant consequence of structural adjustment has been a rise in rural poverty. Using the norm set out by the Planning Commission the head-count ratio measure of poverty for rural India moved as shown in Table 6.
Table 6: Head-count ratio measure of poverty (percentages)

<table>
<thead>
<tr>
<th>NSS Round dated</th>
<th>Rural</th>
<th>Urban</th>
<th>Total</th>
<th>Absolute Numbers, million</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>45.65</td>
<td>40.79</td>
<td>44.48</td>
<td>322.8</td>
</tr>
<tr>
<td>July 1987- June 1988</td>
<td>39.09</td>
<td>38.2</td>
<td>38.86</td>
<td>304.9</td>
</tr>
<tr>
<td>July 1989- June 1990</td>
<td>33.7</td>
<td>36</td>
<td>34.28</td>
<td>276</td>
</tr>
<tr>
<td>June 1990 - July 1991</td>
<td>35.04</td>
<td>35.29</td>
<td>35.11</td>
<td>291</td>
</tr>
<tr>
<td>Jan. 1992- Dec 1992</td>
<td>41.7</td>
<td>37.8</td>
<td>40.7</td>
<td>348</td>
</tr>
<tr>
<td>July 1993- June 1994</td>
<td>37.27</td>
<td>32.36</td>
<td>35.07</td>
<td>320.5</td>
</tr>
<tr>
<td>July 1994- June 1995</td>
<td>38.03</td>
<td>34.24</td>
<td>36.98</td>
<td>329.5</td>
</tr>
<tr>
<td>July 1995 - June 1996</td>
<td>38.29</td>
<td>30.05</td>
<td>36.08</td>
<td>328</td>
</tr>
<tr>
<td>Jan 1997 - Dec 1997</td>
<td>38.46</td>
<td>33.97</td>
<td>37.23</td>
<td>348.8</td>
</tr>
</tbody>
</table>

Note: These estimates, which are by S.P. Gupta based on NSS Surveys, differ slightly from those in Table 10, which are by Ravallion-Dutt and Sen, also based on NSS Surveys. However, the directions of change remain the same.


The veracity of these figures may be questioned on the grounds that they are based (except for the three years 1983, 1987-88 and 1993-94) on consumer expenditure data derived from "thin samples". But it is now quite widely accepted that the thin samples are adequate for deriving conclusions at the all-India level, even though they may not be sufficient to infer movements in individual states. The estimates given here are made by a member of the Planning Commission, Government of India, incorporating information about the more recent years that has just been released. The results are fairly robust in the sense that other researchers have come to very similar conclusions and other social indicators show parallel movements. One element underlying the rise in rural poverty was the sharp increase in the cost-of-living of the working class in general and of agricultural workers in particular (Table 7).

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3See Sen and Patnaik [1997].
Table 7: Increases in the cost-of-living indices (percentages)

<table>
<thead>
<tr>
<th></th>
<th>Agricultural Labourers</th>
<th>Industrial Workers</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985-86 to 1990-91</td>
<td>47.1</td>
<td>53.5</td>
</tr>
<tr>
<td>1990-91 to 1995-96</td>
<td>71.6</td>
<td>62.2</td>
</tr>
<tr>
<td>March 1996 to Dec 1998</td>
<td>40.5</td>
<td>34.5</td>
</tr>
</tbody>
</table>

Source: Calculated from various issues of the Economic Survey.

This acceleration of consumer price inflation in a period of ‘slack’ demand was essentially due to hikes in administered prices which were ordered by the government in order to curtail its subsidy bill, and thereby the fiscal deficit. The commodities whose prices were most severely affected in this manner were foodgrains. As we have already seen, the Indian adjustment strategy has been characterised by attempts to cut consumer subsidy on foodgrain supply through the public distribution system (PDS). This subsidy was already very low by East Asian standards: it has been shown that in most Indian states the value of the income subsidy via the PDS was less than one or two person days of employment per family per month. There were steep hikes in the central issue prices of rice and wheat in December 1991, January 1993 and February 1994. As a consequence of these hikes, by February 1994 the issue price of the common variety of rice had increased by 86 percent compared to the immediate pre-structural adjustment level and of wheat by 72 percent. Subsequently, there have been further sharp hikes in the period 1996-98, as discussed below.

Not surprisingly, this has led to a substantial reduction in purchases from the PDS as the poorest groups were effectively priced out. Total offtake from the PDS is estimated to have declined from 20.8 million tonnes in 1991 to only 14 million tonnes in 1994, and even in 1997 was estimated to be only 17.5 million tonnes.

Subsequently, in 1997 the government introduced a Targeted Public Distribution System in which the price paid by families below the poverty line was reduced by 38 per cent in the case of wheat and 35 per cent in the case of rice, while those paid by families above the poverty line were hiked by 12 and 29 per cent respectively. More recently, in February 1998 the issue prices for families above the poverty line have been hiked by a massive 44 and 29 per cent respectively. It is hardly surprising that the cost-of-living of the workers, both in urban and rural areas, went up so sharply, and that the cost-of-living of agricultural labourers, for whom food is an even more important item in the consumption basket than for industrial workers, went up more steeply than for the latter. In addition, this led to a paradoxical situation whereby there was an involuntary build up of large public foodgrain stocks, so that the carrying costs of these stocks amounted to

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nearly 40 per cent of the total food subsidy expenditure, even as poorer groups were deprived of access. The decline in wage goods availability is a common feature of standard market-oriented adjustment programmes, and the Indian case shows this very clearly.

There was a second element underlying the rise in rural poverty. The level of rural poverty is linked in India not only to the level of food prices relative to wages, but even more pronouncedly to the magnitude of employment opportunities (for which the ratio of rural non-agricultural to agricultural employment is a good proxy, since agriculture is the repository of unused labour reserves). Thus, levels of poverty have been closely associated with not only with overall output and productivity, but also - and critically - with employment generation.

One of the major failures of the adjustment strategy in India has been the inadequate generation of employment. The rate of employment generation has been below both the rate of growth of output and the increase in the labour force. In the four year period 1991-97, total organised sector employment increased by a paltry 5.6 per cent over the entire period, even as industrial output has tripled. Estimates of non-formal employment similarly are very low, as discussed below. According to NSS data, the rate of growth of overall employment has been continuously decelerating since the early 1970s, and for the period 1987-88 to 1993-94 was estimated to be only 2.3 per annum. Recent data suggest that the post-reform growth of total employment, that is in the period 1990-91 to 1997, has been only 1.76 per cent per annum, with an overall employment elasticity of GDP at the low level of 0.29, which is exactly the same as that for the period 1983 to 1990-91.

The disaggregation of aggregate employment into self-employment, regular salaried employment and casual wage employment, also show some disturbing trends. As Table 8 indicates, the expansion of self-employment in the 1990s has decelerated in the 1990s compared to the earlier seven-year period. Regular salaried employment has actually fallen quite substantially, indicating a big fall in both public and private regular employment opportunities. The only category of employment that appears to have registered an acceleration is that on casual contracts, which is usually associated with both lower wages and inferior working conditions and poorer protection of labour.

Table 8: Annual change in employment by category

<table>
<thead>
<tr>
<th></th>
<th>1983 to 1990-91</th>
<th>1990-91 to 1997</th>
</tr>
</thead>
<tbody>
<tr>
<td>Self-employment</td>
<td>-1.72</td>
<td>1.3</td>
</tr>
<tr>
<td>Regular salaried work</td>
<td>7.3</td>
<td>-8.8</td>
</tr>
<tr>
<td>Casual wage employment</td>
<td>-1.1</td>
<td>3.3</td>
</tr>
</tbody>
</table>

The accentuation of unemployment, notably in rural India, in the nineties, has been related to the shift of acreage from food to non-food crops, import liberalization that has led to a demand-switch away from domestic producers, and, above all, cuts in public development expenditure. The Central government's total development expenditure as a proportion of GDP at market prices declined from 12.54 percent in 1985-86 to 7.74 percent in 1996-7. Since government expenditure has a crucial employment generating effect, especially in rural areas, this reduction has been employment-contracting. Similarly, there has been a cut in the ratio of social sector expenditure to GDP, as shown in Table 9.

**Table 9 : Social sector expenditure of union and state governments**

*(per cent of GDP)*

<table>
<thead>
<tr>
<th>Year</th>
<th>Education &amp; culture</th>
<th>Health, Water Supply &amp; Sanitation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989-90</td>
<td>3.36</td>
<td>1.26</td>
</tr>
<tr>
<td>1990-91</td>
<td>3.25</td>
<td>1.23</td>
</tr>
<tr>
<td>1991-92</td>
<td>3.12</td>
<td>1.19</td>
</tr>
<tr>
<td>1992-93</td>
<td>3.04</td>
<td>1.17</td>
</tr>
<tr>
<td>1993-94</td>
<td>3.04</td>
<td>1.19</td>
</tr>
<tr>
<td>1994-95 (RE)</td>
<td>3</td>
<td>1.17</td>
</tr>
<tr>
<td>1995-96 (BE)</td>
<td>2.84</td>
<td>1.12</td>
</tr>
</tbody>
</table>

Source: Alternative Economic Survey 1996-97

The 1980s were characterised by a relatively slow expansion of employment, but also by rising real wages and a fairly substantial drop in both the incidence and the severity of poverty, particularly in rural India. It has been argued that this can be related at least partially to the rapid increase in various subsidies and transfers from government to households, the large increase in revenue (rather than capital) expenditure on agriculture by central and state governments, and a very large increase in rural development expenditure. Thus, while there were some linkage effects with modern industry and commerce in the rural areas, these were geographically limited, and the pivotal role in the expansion of rural non-agricultural employment in particular, may have been played by government in this period.

However, since 1991 government economic strategy has implied further reductions in the employment generation capacity of the organised sector as well as adversely affected rural non-agricultural employment. This is because of the following policies: actual declines in government

\[6\] See Sen and Patnaik [1997].

\[7\] This argument is elaborated in Sen and Ghosh [1993].
spending on rural development in the central budgets, as well as declines in the fertiliser subsidy; reduced central government transfers to state governments which have thereby been forced to cut back on their own spending; diminished real expenditure on rural employment and anti-poverty schemes; declines in public infrastructural and energy investments which affect the rural areas; reduced spread and rise in prices of the public distribution system for food; cuts in social expenditure such as on education, health and sanitation; financial liberalization measures which have effectively reduced the availability of rural credit.

As a result, there has been an absolute decline in rural non-agricultural employment since 1991. This has been accompanied by a large relative shift towards agricultural work, particularly by women, and since the rate of growth of agricultural output has slowed down after the reforms, and there have been increases in rural poverty, this appears to be evidence of a distress shift into agriculture given the lack of alternative income opportunities.  

What is probably most significant is the reversal, since the marketist reforms of the 1990s, of a long run tendency towards the decline of poverty. This process, which is indicated in Table 6, has been particularly marked for the rural areas. This development, too, suggests that the post-reform increase in agricultural employment took place not in the context of greater rural prosperity but reflected greater adversity.

Table 10 : Indicators of rural non farm employment and poverty

<table>
<thead>
<tr>
<th>Year</th>
<th>Rural Non-Agr. Employment</th>
<th>Poverty Ratios</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Male</td>
<td>Female</td>
</tr>
<tr>
<td>1972-73</td>
<td>16.8</td>
<td>10.3</td>
</tr>
<tr>
<td>1977-78</td>
<td>19.4</td>
<td>11.9</td>
</tr>
<tr>
<td>1983</td>
<td>22.5</td>
<td>12.5</td>
</tr>
<tr>
<td>1987-88</td>
<td>25.5</td>
<td>15.3</td>
</tr>
<tr>
<td>1989-90</td>
<td>28.3</td>
<td>18.6</td>
</tr>
<tr>
<td>1990-91</td>
<td>29</td>
<td>15.1</td>
</tr>
<tr>
<td>1991-92</td>
<td>25.1</td>
<td>13.7</td>
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<tr>
<td>1992</td>
<td>24.3</td>
<td>13.8</td>
</tr>
<tr>
<td>1993-94</td>
<td>25.9</td>
<td>13.8</td>
</tr>
</tbody>
</table>

Source: NSS, Sarvekshana, various issues, and Sen [1996].

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8 Further evidence of this is provided in Ghosh [1996].
In urban areas, there has been a trend increase in casual employment and a trend decline in regular employment for both men and women. For men, the increase in casual employment has largely been at the cost of regular employment; and this trend appears to have continued into the post-reform period, although again with some reversal in 1993-94. For women, on the other hand, both casual and regular work appears to have increased after the reforms. In part, this is reflective of the 'feminization' process where a larger share of new urban jobs go to young female employees. But it reflects also a sharp decline in female self-employment immediately during the adjustment process. Here, factors similar to those governing rural non-agricultural employment appear to have played a part in reducing labour demand from such small enterprises where women are self-employed.

In rural areas, on the other hand, a trend of declining self-employment for both males and females appears to have been reversed with the reforms. This is due entirely to an increase in agricultural self-employment, reflecting the shift away from non-agriculture, and is also, in large part, caused by the distress induced increase in female unpaid family work noted earlier. Regular employment has continued to decline and casualisation of wage employment has continued to increase. There has been a particularly sharp increase in female casual employment following the reforms, confirming the distress nature of rural employment developments. Agricultural wages have declined slightly in real terms over the 1990s in several of the most populous states such as UP and Bihar, and have risen only marginally on others. This is likely to have led to falls in real wage incomes given the decline in overall wage employment in the rural areas.

The Indian pattern of feminization of work differs in several very important ways from that which occurred in the second tier NICs of Southeast Asia during their economic boom. First, this growth in female employment relative to that of males was marked equally in agriculture and industry, and was much sharper for subsidiary workers, and not so for principal workers. The opposite tendency prevailed in the export-oriented industries of Southeast Asia until 1996. Second, it occurred in the context of overall stagnation in non-agricultural employment, rather than the tremendous boom in manufacturing employment found in the second-tier Southeast Asian NICs. Third, much of this increase in female employment, especially in agriculture and other forms of self-employment, appeared to be the result of distress conditions determining the supply of labour, rather than intensification of demand as in the high-growth Southeast Asian countries. What was common to both regions was the growing casualisation of female labour in particular, and the clear indication that the growing use of women in the work force was associated with the greater insecurity of labour contracts and the generally inferior conditions and pay involved in employing women rather than men.

3.5 External vulnerability

One important fallout of the adjustment package lies in the increased vulnerability of the Indian economy to speculative pressures. This makes the balance of payments more fragile than ever before. Despite the obsession with and high expectations regarding foreign direct investment

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9 This is documented in the Economic Survey, 1998-99, Government of India.
inflows into the economy, the actual inflows under this head have been relatively minor, not more
than $2 billion per year on average. Most of this has also come into activities catering to the
domestic market which displace domestic producers and constitute implicit de-industrialisation
(owing to the high import content of FDI-based production) rather than into activities, such as
export-oriented production, which genuinely add to domestic output and employment.

What has come in larger measure however is speculative finance capital in the form of `hot
money' on the basis of which India's exchange reserves (at the end of January, 1999) of $27.4
billion have been built up. However, even these have been losing steam over the past year. There
has been a marked slowdown in FDI and a net outflow of FII portfolio investment in 1998-99.
There has also been a large outflow of NRI deposits.

One point which is often missed in discussions on Indian balance of payments is the critical
role that has been played by workers' remittances. Such inward flows, which are classified under
invisible receipts, have contributed more over the 1990s than all forms of foreign investment
(FDI, portfolio capital, Euro-equities and external commercial borrowing and foreign aid) since
the early 1990s. The total amount of all form of foreign investment inflow into the country
between 1992-93 and 1997-98 amounted to $25 billion, while the net receipts on invisible
payments on current account in the same period came to $36 billion - that is 44 per cent more. In
the latest year for which data are available, 1998-99, remittances alone account for more than $11
billion, more than all foreign investment inflows put together.

Despite these inflows that have kept the current account deficit under control, the balance
of payments situation is not exactly comfortable at present. The deceleration of exports and
worsening trade balance suggest that it may be only a matter of time before some degree of
payments difficulty is experienced. Also, while the reliance on short-term flows in India has been
far short of the levels in the crisis-affected Southeast Asian countries, it remains substantial
enough to be a source of concern and to put pressure on domestic policy-making in terms of the
need to placate and reassure international investors (who, incidentally, may be domestic in origin
as well). But to a significant degree, the controls that still do remain on the capital account, and
the absence of full convertibility of the rupee, have constrained both the uninhibited inflow of
foreign capital which Southeast Asia experienced, as well as the possibility of reversal of investor
confidence leading to huge and sudden outflows. This is not to say that such possibilities do not
exist at all, as is considered once again in Section IV below.

4. Policy lessons from Southeast Asia

4.1 The unfolding of the crisis

Since every narrative needs a beginning, the now voluminous literature on the East Asian
crisis dates it to the 2nd of July 1997, when the Thai currency, the baht, was allowed to float.
This date is chosen despite the fact that signs of impending problems were evident in several of
these economies for some months before. In Thailand, for example, there had been speculative
attacks on the currency from around August 1996, which were warded off only with great
difficulty by the Thai government, and the balance of payments imbalances which triggered such
speculative attacks were clear from early 1996. (See, for example, Ghosh et al, 1996.) Similarly,
in Malaysia and Indonesia as well, it had been evident at least from early 1997 that speculative pressure could affect currency values, and the first signs of financial difficulties in the Republic of Korea came with the loan defaults by some companies in January 1997.

The reason why most observers focus on the floatation of the Thai *baht* when dating the origins of the crisis is to be found in the fact that it was the most obvious symptom of both the crisis in that country and the contagion effect that followed. The *baht* quickly depreciated against the dollar and the financial contagion that followed led to collapsing currencies and slumping stock markets across the region. The slump in currencies resulted from a huge increase in the demand for foreign exchange, which was triggered by three factors. First, a collapse in investor confidence resulted in a panic withdrawal of funds invested in equities and prevented the roll-over of short term debt. Second, there was a scramble for dollars on the part of domestic banks and corporations with imminent dollar commitments, in order to cut their likely losses from further depreciation of domestic currencies. And finally, there was an increase in speculative operations by domestic and international traders cashing in on currency volatility. These factors operated - to greater or lesser degree - in most East and Southeast Asian economies, barring certain exceptions like China and Taiwan, China, which are considered below.

The real economic crisis appeared well after this financial collapse, especially after the IMF was called in and sanctioned financial packages of $16 billion for Thailand on August 11, $23 billion to Indonesia on October 31 and a massive $57 billion to Korea on December 4. With a combination of a liquidity crunch, bankruptcies and IMF-sponsored deflation playing its role, not only did economic growth decelerate, but there was soon a contraction of domestic manufacturing output and GDP in these countries. Given the close integration through trade of the Asian economies, as well as the regional nature of capital flows, this contraction has affected even those that did not opt for the IMF route to stabilization.

The effect has been a recessionary spiral, with contractionary forces feeding into each other, so that throughout the first half of 1998, growth projections had to be continuously revised downwards. From late 1998 the situation appeared to have stabilised in terms of reduced currency volatility, although the real economies continue to be in slump. The inability of Japan to respond positively in helping to deal with the crisis - first because it was persuaded by the United States to abandon its plan for a regional fund in mid-1997, second because the regional recession has added to the problems its domestic companies face, and third because of its difficulties in dealing with problems in its own banking sector - has added to the pressures making for economic depression. Most current projections of economic "growth" in the region anticipate that there may be several more years before recovery. Thus Thailand is expected to regain the level of its 1996 output only by 2002, and the Republic of Korea by 2001 at the earliest.

The convergence of recent economic disaster across the East Asian economies should not blind us to the fact that their development trajectories and levels of performance have differed substantially. The Republic of Korea is known to have pursued a state-directed and highly regulated export-led growth strategy, which only recently has given way to a more liberalised regime. Malaysia and Thailand by contrast have a much more recent history of rapid economic growth, characterised by open economic regimes within which foreign direct investment played a crucial role in delivering both export and output growth. Oil revenues and a strong State relying
on internal and external clientelist relations have played an important role in Indonesia's development path. The Philippines was never really much of a "tiger" except in the matter of export growth, and that has not translated yet into any major transformation of domestic productive structures.

Table 11: Export growth trends in the region annual percentage change of dollar value

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Even at the start of the crisis in mid-1997, economic performance in the region differed substantially, although all of them had recorded a significant deceleration in export growth in 1996 (Table 9). Thailand, for example, had recorded an absolute 1 percent decline in its exports in the previous year and was saddled with a huge current account deficit on its balance of payments. It had experienced a slowing of FDI inflows in recent years, which, given its pattern of growth, spelt a weakening economy and growing dependence on short term financial flows. Malaysia also had a large current account deficit, financed to a lesser degree by "hot" money flows made possible by the open capital account, and some of the typical effects of "overvaluation" including excess resources directed towards real estate. Indonesia, on the other hand, had much less of a current account problem, and did not even suffer so much of a deceleration in export growth. The Republic of Korea, whose current account deficit and public debt amounted to just 3 per cent of GDP, appeared stronger than many OECD countries when it won membership of the rich nations’ club. Hence, the deceleration in exports first appeared to be a mere cyclical downturn that could be dealt with, as still appears true in the case of China. This was supported by the fact that unlike other countries in the region, while the growth of export value in the Republic of Korea fell from 30 per cent in 1995 to 4 per cent in 1996, the growth in volume of exports fell from 24 per cent to just 19 per cent.

These differences suggest that the same or similar economic “fundamentals” could not have led to the crisis in these economies. Nevertheless, in all of these countries the crisis took the same form of a collapse of currencies and stock markets, and there was a high degree of synchronisation of such capital market collapse.
The response to these developments in the form of a loss of investor confidence and a tendency towards capital flight began in Southeast Asia’s weakest link: Thailand. The flow of portfolio capital slowed and creditors refused to roll over short term debt. That turn of events encouraged currency speculators, domestic and foreign, to enter the picture, leading to a collapse in currency values. Once this process began, however, the ‘contagion’ spread to other countries, with far stronger economies and larger foreign reserves. Given developments in the world economy and the region, there was always some adverse ‘fundamental’ that could provide the basis for a loss of investor confidence. In the Republic of Korea, for example, it was the fact that banks had been under pressure to lend to overextended business groups, that were taking a beating in international markets and could not cross-subsidise their loss-making operations with profitable ones. Banks had therefore to take on huge short term loans to keep these chaebols afloat, resulting in the fact that such loans were estimated at more than $100 billion at the time of the crisis. When creditors refused to roll over those loans a collapse of reserves and of the won ensued. This meant that even weak and transient signals of adverse economic performance were enough to set off the train of events that end with a speculative attack on the currency. Thus, currency volatility being the immediate consequence of the volatility of investor confidence and international financial flows, it became the common symptom of rather widely varying economic difficulties. The problem, however, is that the symptom soon worsened the affliction.

To fathom this common denouement to widely varying plots, we need to turn to the realm of finance, which is explored below. But it is also necessary to identify the proximate “real causes” of the dramatic decline in economic performance in virtually all of these countries.

4.2 The limits of export dependence

Insofar as it is possible to isolate the original sin in this particular Asian drama, it must lie in the deceleration of export growth that was experienced by the entire region from about the middle of 1995. In the decade preceding this year, as is well known, the Asian region, and particularly East and Southeast Asia, was the most dynamic in the world in terms of economic growth as well as increased trade involvement. Both in terms of the growth rate of GDP and the rate of export growth, the developing economies of Asia in the aggregate outperformed any other grouping. In addition, the dominant share of capital flows to the developing world was absorbed by Asia, and by a small set of countries (such as China) within Asia, but the jury is still out on whether this was the cause or the effect of high growth.

It is now almost universally accepted that while in terms of the degree of openness and the extent of intervention by the State in the functioning of markets, the East Asian countries pursued widely varying strategies, the common element in those strategies was the crucial role of exports in sustaining their high growth rates. Most of these Asian countries have experienced deceleration or decline in their manufactured exports since the middle of 1995. While the causes for this sudden drop have still not been adequately explored, much may be due to the fact that successful export growth has its costs, especially when it is such rapid growth that it involves continuously increasing international market shares. It invites retaliatory action from countries which are the targets of that export drive, it leads to a loss of GSP Preferences, it triggers a rise in domestic wages, it often results in infrastructural bottlenecks. All of this in fact happened, and it tended to
undermine the very export competitiveness that underlay the high rates of growth in these countries.

Those who extolled the export-orientation in these countries and the associated “flying geese” phenomenon which saw such a strategy replicated in new countries in the region, recognised this reality. But they also presumed that the early new industrialisers (NIEs) would in response successfully diversify into more technology-intensive, high-end sectors and sustain their export drive. This was partially true. But what also happened is that intra-regional investment flows created similar capacities as those which characterised the “early East Asian industrialisers”, in newer and more competitive locations. To the extent that this has resulted in competition within the Asian region among those seeking the same markets abroad for the same markets, older suppliers have often lost out in the competitive battle that has ensued.

Nothing illustrates this more than patterns of world trade in the “office automation” and consumer electronics sectors. Most Asian countries have experienced deceleration or decline in their manufactured exports since the middle of 1995, and the causes for this sudden drop have still not been adequately explored. One factor most commonly cited is the saturation of developed country markets, particularly for the office automation and telecom equipment segment and the machinery & transport equipment category. In the case of most of the high-exporting countries, these accounted for an overwhelmingly large share of total exports. The slowdown of trade growth in these categories therefore had a disproportionate effect on their exports.

If we examine the relative shares of the main 11 SITC product groups\textsuperscript{10} in total merchandise trade in 1996, we find that since 1985, these shares have varied little, with two exceptions: the share of mining products (including both fuels and ores and minerals) has declined from 22 to 11 per cent (due mainly to a decline in the value of trade in petroleum because of falling oil prices), while that of machinery and transport equipment has increased from 31.0 to 38.8 per cent (WTO, 1997). Two items of significance within the latter category were office machines and telecom equipment and automotive products, whose share of merchandise exports stood at 12.2 and 9.2 per cent respectively in 1996. Of these two, office automation and telecom equipment constituted a major export for developing Asia (excluding Australia, Japan and New Zealand), accounting for 26.3 per cent of their total merchandise trade in 1996. If the 1996 shares are compared with those for 1984, the share of office and telecommunications equipment in world merchandise trade nearly doubled over the 12 years, from 6½ to just over 12 per cent. Thus, telecommunications and office equipment have made important contributions to world trade growth in recent years, with rates of export growth which were higher than the average for all commodities. It could therefore be argued that a slump in the market for those commodities would have affected Asian trade performance quite adversely, given the importance of those commodities in East Asia’s export basket.

\textsuperscript{10} The relevant product groups are: Food; Agricultural raw materials; Ores, minerals and non-ferrous metals; Fuels; Iron and steel; Chemicals; Other semi-manufactures; Machinery and transport equipment; Textiles; Clothing; and Other consumer goods.
This argument carries weight for a number of reasons: (i) if we take the six principal items of consumer electronics, office equipment and telecommunications, the 8 East Asian economies accounted for 46 per cent of developing country exports of these items and 9.5 per cent of world exports in 1990/91; (ii) these commodities accounted for a significant share (15.4 per cent) of merchandise exports from these 8 countries; and (iii) since these were the most dynamic areas in world trade growth during the last decade and a half, East Asian success in exports in these areas would have allowed them to ride the boom in this segment while being insulated from the slump in others. This partly explains the divergence in the growth performance of these economies compared with the rest of the world.

However, what is perhaps more crucial is that the saturation in the market for these items has set off a competitive struggle among economies in the region which have specialised excessively in these areas because of intra-regional investment flows. The gainers have been the winners in that competitive battle like the Philippines, or those countries which have not specialised in such products. The Philippines doubled its exports of office automation and telecom equipment in two years, from $5047 million in 1994 to $10056 million in 1996. These items therefore came to account for almost half its merchandise exports in 1996. Such growth must have triggered a price war besides slowing export growth in other Asian economies.

On the other hand, China is a country in which none of these products, excepting Radio Broadcast Receivers, featured in its list of principal exports. Its export dynamism has been based on a number of traditional manufactured exports like textiles and clothing for example, which accounted for 25 per cent of its manufactured exports in 1996. That is, China’s trading strength lies in areas in which the leading East Asian traders have lost their competitiveness much earlier, forcing them to gradually vacate the markets for such exports. Much has been made of the Chinese devaluation of the Renminbi in 1994, which dramatically increased Chinese export competitiveness vis-à-vis the other East and Southeast Asian economies, but this was only one of the factors which contributed to the shift.

Thus, the trade experience of the East Asian countries afflicted by the currency crisis has indeed been specific, inasmuch as it reflects a fall in export volume growth and unit values triggered by an excessive specialisation through relocation in areas where capacity growth has come to exceed market growth. These problems were inherent in the trade strategies they were following. It was to deal with these problems, that many of these countries chose to diversify out of manufacturing into services in general and financial services in particular. Both the Republic of Korea and Thailand shared ambitions of becoming the financial hub of the East, and seeing a sharp rise in the services component of their GDP. Financial liberalisation was therefore seen as the means to achieve this end, as well as meet pressures from the developed industrial nations to open up the financial sector as a quid pro quo for keeping open developed-country markets for manufactured exports from the East. As a result, during the early 1990s, almost all East Asian countries liberalised their financial sectors and allowed local corporations, banks, and non-bank financial institutions to freely access international capital markets with little commitment to earn the foreign exchange needed to service the costs of such access.

But that was not all. The period of rapid export growth was also one in which imports were allowed to grow at an even faster rate, through the progressive liberalisation of imports in these
countries. The reliance on substantial capital inflows, first as FDI and then in the form of portfolio investment and short-term borrowing, ensured that the large and growing current account deficits could be easily financed. And it also meant that market pressure on currencies was upward, and that these countries experienced real appreciation of their exchange rates.

An appreciating real exchange rate encourages investment in non-tradable sectors, the most obvious being real estate, and in domestic asset markets generally. Given the differential in interest rates between domestic and international markets and the lack of any prudence on the part of international lenders and investors, local agents borrowed heavily abroad to directly or indirectly invest in the property and stock markets. The resulting boom generated the incomes to keep domestic demand and growth growing at relatively high rates. This soon resulted in signs of macroeconomic imbalance, not in the form of rising fiscal deficits of the government, but a current account deficit reflecting the consequences of debt-financed private profligacy. It was inevitable that this would soon result in a collapse of investor confidence. When that did occur, capital was pulled out and currencies depreciated, those with dollar commitments in the offing rushed into the market to purchase dollars early and cut their losses. The spiral continued, generating a liquidity crunch and a wave of bankruptcy. 11

The implications of the above argument should be clear. The proximate cause for the East Asian crisis, its spread (which is inadequately captured by the notion of a “contagion effect”) and its similarity in terms of principal symptoms across countries with rather diverse economic histories, have all to do with one commonality cross the region. This was the rapidity with which they opted for financial liberalisation and the access to international liquidity this provided in early 1990s. It cannot be denied that excessive dependence on foreign capital inflows, especially short term debt, is an important explanatory factor for the nature and the severity of the crisis in East Asia. But a fuller explanation must touch on a related set of issues: Why did these countries, with remarkably high domestic savings and investment rates, choose to invite foreign capital flows of this magnitude? And why did capital from the ostensibly more transparent and rule-based financial systems in the more developed financial markets choose to invest sums in these countries which we know, with hindsight, were far beyond their capacities to absorb? These issues are considered below.

4.3 Financial liberalisation and crisis

The wave of financial liberalisation in the developing countries in the 1990s, can be at least partly explained by a similar wave in industrial capitalist countries in the late 1980s, which led to a pyramidal growth in financial assets. While this did increase the fragility of the system, it was also seen as an opportunity. Substantially enhanced flows to developing countries, initially in the form of debt and subsequently in the form of debt and portfolio investments led to two consequences. First, the notion of external vulnerability which underlay the interventionist strategies of the 1950s and 1960s no longer seemed relevant - after all any current account deficit could be financed, it appeared, as long as such capital inflows were assured. Second, growth was now easier to ensure

11 Chandrasekhar and Ghosh [1999] elaborate this argument.
without having to confront domestic vested interests, since international liquidity could be used not merely to finance current and capital expenditures but also to ease any supply side constraints that would otherwise constrain such growth.

In the case of East Asia, these arguments could be dismissed on the grounds that growth was hardly a problem. Most of the countries in this region had very high domestic savings rates, in the region of 25 to 30 per cent of GDP, and their accumulation strategies dominantly relied on such internal resources. However, there is reason to believe that, despite their high savings rates, the decision to liberalise finance and allow free capital inflows was not only the result of external pressures, such as advice from the multilateral finance institutions or (in the Republic of Korea’s case) the desire to become a member of the OECD. It could be argued that greater financial openness was at least in part the result of a growing inability in these countries to sustain the export-based miracle growth rates that had made them the favourites of international capital. As we have argued earlier, an excessive dependence on exports soon triggers a search for alternative sources of growth, and in these cases the choice fell on the opportunities generated from being a regional financial centre. In almost all of these countries, financial liberalization was thought to be the route to seize that opportunity. Of course, this choice was not altogether fortuitous.

This resulted in one commonality in all the East Asian countries, namely their growing exposure to international finance in the wake of financial liberalization. In the form of investments in stock markets and foreign debt incurred by banks and corporate groups, the presence of internationally mobile capital was unusually high in all of them. Such reliance on mobile foreign finance meant that any factor that spelt an economic setback, however small or transient, could trigger an outflow of capital as well. As mentioned earlier the last couple of years have witnessed a number of developments which spelt such a setback.

Ever since the debt crisis and the rescheduling exercises that followed, international banks, while wary of developing-country lending, have been convinced that the losses they can incur in developing-country markets are limited by the implicit sovereign guarantee of loans to private borrowers, both by governments in the developed and developing countries. This is the case even when the loans that are made are not officially guaranteed by the governments of the debtor companies, because of the assumption that in cases of real difficulty governments will be forced to step in and underwrite such loans, with or without IMF pressure. As a consequence, none of the standard prudential norms which would have applied in the home countries was closely followed by creditors or other investors. The fact that the domestic banking and finance sectors in these countries were subject to prudential regulation was not an adequate safeguard against this, which turned out to have extremely dire implications for the borrowing countries.

This points to the futility of believing that capital account convertibility accompanied by domestic prudential regulation will ensure against such boom-bust volatility in capital markets. The fact that the IMF-negotiated bailout in the Republic of Korea involved banks converting $24 billion of short term debt into medium-term debt guaranteed by the government, at an interest rate ranging from 2.25 to 2.75 percentage points above LIBOR, illustrates once again why such policy mistakes occur. International banks have to pay little penalty, if anything at all, for their lack of diligence.
The question therefore is why the East Asian economies chose to approach the international financial markets for such funds despite their high domestic savings rate. The explanation lies in the “autonomous” tendencies generated by financial liberalization in these economies over the past decade. By allowing domestic financial agents to approach foreign financial institutions directly, liberalization had two consequences. First, it provided them a source of “easy finance” when they found themselves overstretched domestically, because corporations or institutions to whom they had overexposed themselves are finding it difficult to service past credit without access to new loans. Second, they had a source of finance which could be used to fund risky activities (like those accompanying a property or stock market boom), since the ‘original’ investors asked few questions. Such tendencies can be damaging because of a more fundamental consequence of both trade and financial liberalization: the dissociation of any increase in foreign exchange commitments of individual agents from their ability to contribute to the earnings of foreign exchange needed to service those debts.

It is true that Indonesia and Malaysia had open capital accounts for very long periods, but this has generally reflected their ability to access foreign funds because of geopolitical considerations, as well as the close nexus established over this period between domestic capitalists, foreign investors and the state in these countries. Also, earlier these could still be effectively regulated because a large proportion of the transactions until the 1990s were effectively state-controlled. In the 1990s, the external capital transactions of private agents within these economies became much more pronounced, and the freedom regarding commercial borrowing from abroad allowed private companies to completely delink the taking on of foreign exchange obligations from the ability to service them in foreign exchange. It was therefore the fact that financial openness allowed profligacy on the part of private agents that was an important cause of subsequent problems.

The case of Thailand is particularly instructive, because it shows how misplaced is the general obsession with government deficits as creating the only unsustainable external imbalances. Initially Thai current account deficits - which reflected the excess of private sector investment over private savings, since the government account was typically in surplus - were financed with FDI inflows which also supported the country's export effort and raised the rate of growth. However, the situation changed after 1990. While FDI inflows were slowing, exports were not growing fast enough to finance burgeoning imports. The ‘structural deficit’ in Thailand's current account stemming from the openness of it economic regime, was no longer accompanied by adequate inflows of private direct foreign investment. To finance its external deficits, therefore, Thailand had to resort to borrowing from international credit markets, implying a rapid increase in external debt. Much of this was necessarily short-term debt, which is very susceptible to the level of investor confidence. Financial markets had been concentrating on the rate of export growth as the single most important indicator of creditworthiness, rather than the external imbalance, and once the export deceleration led to an increase in the projected current account deficit, the decline of the baht began. The initial decline forced domestic operators with foreign exchange service commitments in the near future to rush into the market to acquire dollars and reduce their losses in terms of the domestic currency, triggering a run on the currency fuelled by financial speculators.
The relatively prolonged period of exchange rate stability in these countries, with most currencies pegged to the US dollar, had created complacency about possible changes, and high export growth also lulled policy-makers into believing that continued access to foreign exchange would never be a problem. As a result, the capital account transactions in virtually all of these countries began to reflect substantial market failures in ways that went largely undetected. The most obvious failure, in terms of foreign exchange balancing, has already been mentioned.

One very common conclusion that has been constantly repeated since the start of the Asian crisis in mid 1997 is the importance of "sound" macroeconomic policies, once financial flows have been liberalised. It has been suggested that countries like Thailand, the Republic of Korea and Indonesia have faced such problems because they allowed their current account deficits to become too large, reflecting too great an excess of private domestic investment over private savings. This belated realisation is a change from the earlier obsession with government fiscal deficits as the only macroeconomic imbalance worth caring about, but it still misses the basic point.

This point is that, with completely unbridled capital flows, it is no longer possible for a country to control the amount of capital inflow or outflow, and both movements can create consequences which are undesirable. If, for example, a country is suddenly chosen as a preferred site for foreign portfolio investment, it can lead to huge inflows which in turn cause the currency to appreciate, thus encouraging investment in non-tradeables rather than tradeables, and altering domestic relative prices and therefore incentives. Simultaneously, unless the inflows of capital are simply (and wastefully) stored up in the form of accumulated foreign exchange reserves, they must necessarily be associated with current account deficits. The large current deficits in Thailand and elsewhere therefore were necessary by-products of the surge in capital inflow, and that was the basic macroeconomic problem.

This means that any country which does not exercise some sort of control or moderation over private capital inflows can be subject to very similar pressures. These then create the conditions for their own eventual reversal, when the current account deficits are suddenly perceived to be too large or unsustainable. In other words, what all this means is that once there are completely free capital flows and completely open access to external borrowing by private domestic agents, there can be no "prudent" macroeconomic policy; the overall domestic balances or imbalances will change according to the behaviour of capital flows, which will themselves respond to the economic dynamics that they have set into motion.

In terms of the internal pressures for financial liberalization, the process in the Republic of Korea deserves a closer look. It is widely accepted that controlled finance was one of the prime instruments with which the State in the Republic of Korea guided industry in directions which made it an international industrial powerhouse. State-owned or backed financial entities were allowed to mobilise resources both domestically and through borrowing abroad to fund industrial investment. Using these financial institutions as instruments of control, the government forced industry to comply with its industrial growth strategy, but ‘paid off’ investments in less profitable areas with differential interest rates that implied negative real (or inflation-adjusted) interest rates in some sectors. The financial sector was powerful not merely because it was the conduit for cheap investment funds, but because it functioned as an arm of the State's economic apparatus, encouraging and monitoring industrial investments. In fact, driven by the industrial success of
Japan and the Republic of Korea, many analysts have argued in favour of the merits of a ‘bank-based monitoring system’ rather than a (stock) ‘market-based monitoring system’, as prevails in the United States.

With the benefit of hindsight, it is clear that there are two types of problems with such bank-based systems. First, they fail to deal with the question of who is to monitor the monitor? The Republic of Korea's banks, backed by corrupt and/or well-meaning politicians, lent heavily to a few State-created business groups (chaebols), which diversified into a wide range of areas based on cheap credit and an initially cheap and docile labour force. This helped deliver the Republic of Korea's success as an internationally competitive producer. But it also meant that these business groups were highly overgeared, with the ratio of debt to equity used to finance their investments often ranging between 300 and 500 per cent. Further, these banks not only accepted property as collateral for their profligate lending but themselves resorted to speculative investments in the property market which, as in much of Southeast Asia, registered a boom along with industrial growth.

The slowdown of industrial and export growth meant that many of the Republic of Korea's conglomerates were unable to service their huge loans. This, together with the end of the property boom, meant that the Republic of Korea's banks were saddled with huge volumes of non-performing assets necessitating the closure of some and the restructuring of others. This has been the core of the Republic of Korea's crisis. With the State being closely tied to these financial intermediaries, it cannot but take the responsibility for depositors’ funds and for the restructuring of the financial system. It is for this reason that it needs resources currently estimated at $60 billion and more.

The second problem characterising the Republic of Korean strategy stems from the immense power it gave to a newly emerging financial class. Being in the nature of functionaries rather than owners of capital which the State helped them to accumulate, the members of this class would have had a very different attitude to the State from that of the Republic of Korea's State-created industrial class. And, being the principal link with foreign capital in a country which resorted to large scale commercial borrowing, but assiduously discouraged foreign investment in industry, their openness to “integration” with the international economy tends to be greater. These attitudes could not but have influenced the conduct of economic policy in the more democratic political regime fashioned by the militancy of the Republic of Korea's student community and its working class. Democracy has meant that the close links between the State and industrial capital, involving mutual favours and payoffs, is increasingly under challenge. Politicians and industrialists have had to pay a price for the corrupt nexus that democracy has helped to reveal. But democracy has also brought with it the pressure for a greater degree of openness vis-à-vis the international system. There is reason to believe that in the economic sphere this pressure towards openness comes more from the financial sector rather than from an industry which gained its foothold in international markets on the basis of State support and a protected economic regime.
4.4 Elusive recovery: why the crisis continues

The financial and economic crisis in the Southeast Asian region was seen as a cause for international concern not only because of its severity but also because of its sheer longevity, with the economic collapse from mid-1997 continuing well into this year. Recently, however, the international financial media has been full of reports of the final arrival of the much desired and long awaited "recovery" in East Asia. Even the IMF appears to be heaving a sigh of relief that the prolonged crisis in the region is now on the wane.

The immediate source of such optimism is evidence of a shift from GDP contraction to moderate GDP growth in two of the crisis-afflicted countries in the region, the Republic of Korea and Thailand. In Thailand, after declining by 0.4 per cent in 1997 and 8 per cent in 1998, GDP is expected to increase by 1 per cent this year. There is a similar story of recovery of GDP growth in the Republic of Korea. After declining by 5.5 per cent in 1998, GDP is reported to have risen by 4.6 per cent in the first quarter of 1999, kindling hopes that earlier projections of 2 per cent growth over the whole of the year would be exceeded. This return to positive growth comes in the wake of increasing evidence of financial stability: exchange rates in these countries have stabilised, interest rates are down, and inflation is moderate. This return to positive growth comes in the wake of increasing evidence of financial stability: exchange rates in these countries have stabilised, interest rates are down, and inflation is moderate.

However, moving from these early signs of what may be an incipient turnaround to more medium-term or long-term prognoses requires an understanding of what accounts for the recent changes in economic trends in these countries. The process of financial stabilisation is of course easier to explain. It is in large measure the result of the massive import contraction in the wake of the crisis that delivered huge current account surpluses and eased the balance of payments situation. In the Republic of Korea's case, the current account deficit which stood at $23 billion in 1996 and $8.2 billion in 1997, was transformed into a surplus of $40 billion in 1998. Thailand, which was running current account deficits of around 8 per cent of GDP in 1996, registered a small surplus of $3.1 billion in 1997, which then rose to $14.3 billion in 1998. Even during the first two months of 1999, the surplus on the current account amounted to $2.6 billion.

However, much of this additional money is likely to have been used up by firms to meet the huge debts they had accumulated in the past, and could have contributed little to a recovery in demand. In fact the evidence is clear that private investment demand has taken a beating in the wake of the crisis and there is little sign of a turn around. The behaviour of gross capital formation in the Republic of Korea tells a similar story. Nor have exports provided a demand stimulus, despite the huge depreciation in the value of currencies in these countries. The value of exports from Thailand fell by 3 per cent in the first quarter of this year, after having fallen by close to 7 per cent during 1998. In the Republic of Korea too exports have fallen by an average of 5 per cent during the first four months of 1999 after a decline of 2.8 per cent over 1998 as a whole. [Incidentally, the continued decline of exports even after the very large movements of currency depreciation of 1997, point to the importance of identifying structural features responsible for export performance, rather than looking at price variables alone.]

The only explanation, therefore, for the turn from hugely negative to moderately positive rates of growth is expansionary spending by governments in these countries. The IMF, which had
started its restructuring effort in Asia with the demand for surpluses in the Korean and Thai budgets, has gradually allowed for a shift in the targeted level of the fiscal deficit in these countries to as much as 5 per cent of GDP in the case of Korea and 6 per cent in the case of Thailand. The problem is that the extent of revival in demand, in the wake of deficit-spending of magnitudes the IMF and the World Bank considers unacceptable in other contexts, has been moderate at best, and actually inadequate especially when seen in the context of the curtailment of demand that post-crisis restructuring is likely to involve. A crucial component of that restructuring is the retrenchment of firms and institutions that are overburdened with debt and need more loans to stay afloat. The process of financial and corporate restructuring, which is likely to curtail credit and dampen investment and consumption demand in these countries, has hardly begun. As the process of restructuring gains momentum, a further bout of output contraction is inevitable, which is unlikely to be neutralised by the moderate growth in output delivered by current levels of deficit spending.

This would add to the already significant social tensions generated by the job losses that have already occurred and the further worker retrenchment that appears likely. As the analysis by the ILO [1999] has pointed out, these negative social effects of the crisis are worrisome in themselves, but they also have a tendency to feed into economic processes which may make the task of recovery even more difficult in the medium term.

Sustainable recovery in these countries requires a different strategy. It involves a turn away from the excessive openness resulting from the mad pursuit of easily accessed foreign capital. For a time, the sheer availability of such finance, at least for a minority of highly publicised emerging markets, had convinced developing countries that the problems of external vulnerability which had warranted the earlier import substituting industrial policies are no longer relevant. Now, however, there is greater realisation that these problems of external vulnerability have not gone away, and can be as vicious as ever. This has meant a revival of policy ideas that are based on some degree of insulation from the vagaries of international markets, particularly financial markets. While a full return to the earlier forms of import-substituting regime is obviously not advisable, the only way in which fiscal deficits can be used to trigger growth is if there exists an "area of control" insulated from the debilitating consequences of the free flow of capital, goods and services.

The IMF too has learnt some lessons. It has not only backed a call for "strengthening the international financial architecture", but also cautioned countries against hastening towards capital account convertibility, and chosen to put on hold its call for fiscal contraction in East Asia. The explanations for this superficial change in perspective are not hard to find. First, with the near-collapse of hedge funds like Long Term Capital Management in the United States, it is increasingly becoming clear that "lack of transparency" is not a problem typical of emerging markets but rather is a feature intrinsic to the liberalised and proliferating global financial system. The international banking system, in search of the high returns promised by risky investments, had lent such funds sums that were many multiples of their capital base, and helped fuel a speculative boom in both emerging markets and developed country stock markets. As the expectations on which such investments were made have been belied, there is a real threat of a collapse of the speculative bubble, and even of that collapse driving the developed industrial nations into a deep recession. Secondly, it has become clear that the restoration of at least a semblance of growth and
stability in the Asian region, in the economies in transition and in Latin America is a prerequisite for stalling a global recession, which now is a real possibility. With the consequences of liberalised finance being felt closer to home, developed country governments and the international financial institutions have woken up to the fact that unregulated finance creates financial and real instability.

Despite such knowledge, there still appears to be no forgiveness on the part of the IMF, in terms of changing the core policies it prescribes for developing countries facing balance of payments difficulties. In particular, international policy-making circles still refuse to come to terms with the link between export dependence, financial openness and instability. Even though the IMF has belatedly diluted its basic remedy of high interest rates, cuts in government spending and other deflationary measures which have exacerbated the crisis, it appears to be anxious to ensure that the most obvious conclusion regarding the need to regulate capital flows is not drawn, and that other developing countries do not follow Malaysia in instituting some forms of currency control. Further, it fears that faced with inadequate capital flows, developing countries may be encouraged to partially insulate their economies, thereby creating a national space within which they could seek to spur growth with government spending. Thus, in the IMF's view, "in all countries, it is particularly important that the difficult external environment does not lead to defensive exchange rate and trade actions with negative international consequences or to market-closing measures." (IMF, 1998 : 4) All this is seen as a prerequisite for restoring foreign investor confidence and wooing back the same foreign capital which had created all the problems in the first place.

There has been widespread criticism of the IMF's East Asia strategy, not only from the World Bank, but from independent analysts (see, for example, Wade and Veneroso, 1998; Bullard et al, 1998) and even those who were earlier very bullish about all forms of economic openness and globalisation.¹²

Despite its unpopularity, however, IMF continues to hold on to what is still in essence its earlier position. This reflects not only the structure of power within that organisation, but also the persistence of its beliefs regarding how current capitalism works. The IMF obviously believes that restoration of capital inflows is the only viable route to recovery in these countries, and that liberalization aimed at facilitating such flows and macroeconomic and financial policies aimed at attracting them form the only acceptable response to the crisis in these countries. Such beliefs are based on the premise that investor confidence in a world of globalised finance is country specific and that the "fundamentals" that spur such confidence are not undermined by greater financial openness.

5. Ramifications of the Southeast Asian crisis

¹² Thus, in a recent article, Radelet and Sachs criticise mainstream assessments of the crisis by pointing out that just as Jawaharlal Nehru had once famously remarked that history is written by the victors, so "financial history, it seems, is written by the creditors". They admit that "the crisis was not the inevitable result of an Asian capitalist model, but rather, an accident of partial financial reforms that exposed these economies more directly to the instability of international financial markets". (Radelet and Sachs, 1998 : 23)
5.1 The nature of investor confidence

It is now clear that the all too brief period when the financial markets of some developing countries and economies in transition were seen as the favoured destination of international investors, is over for the time being. The outlook for most emerging markets is muddy if not definitively negative. According to IMF projections, total net capital flows to all developing countries are likely to decline from last year's levels by more than $90 billion, or around 40 per cent. Tables 12, 13 and 14 give more detailed estimates from the IMF for Asia, Latin America and East European economies in transition. As expected, Asia shows the most dramatic change, which is not simply a decline but a reversal to a substantial net outflow of more than $18 billion. (IMF, 1998)

Data on gross private financial flows to emerging markets indicate that gross (or new) financing peaked in the second and third quarters of 1997, and that in the first half of 1998 it was running at about half of pre-crisis levels. Asia has accounted for most of the decline in gross flows since mid-1997, but flows to other regions have also been adversely affected. In August, gross financing virtually dried up, reflecting the turbulence in Russia and other emerging markets. As a result of all this, net private capital flows in 1998 as a whole have been estimated by the IMF to be a further $44 billion lower than in 1997, at around $87.6 billion. This is less than half the net inflow recorded in 1996.

Table 12: Net capital flows to Asia ($bn)

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</tr>
</thead>
<tbody>
<tr>
<td>Net private capital</td>
<td>13.1</td>
<td>56</td>
<td>64.8</td>
<td>91.7</td>
<td>100.2</td>
<td>21.5</td>
<td>-18.3</td>
<td>-7.3</td>
</tr>
<tr>
<td>flows</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net direct</td>
<td>4.5</td>
<td>32.9</td>
<td>44.4</td>
<td>51</td>
<td>60.2</td>
<td>60.2</td>
<td>45.1</td>
<td>35</td>
</tr>
<tr>
<td>investment</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net portfolio</td>
<td>1.5</td>
<td>6.7</td>
<td>11.5</td>
<td>10</td>
<td>10.1</td>
<td>7.5</td>
<td>-6.5</td>
<td>-3</td>
</tr>
<tr>
<td>investment</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other net</td>
<td>7</td>
<td>16.4</td>
<td>9</td>
<td>30.8</td>
<td>29.9</td>
<td>-46.3</td>
<td>-56.9</td>
<td>-39.3</td>
</tr>
<tr>
<td>investment</td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net official flows</td>
<td>7.8</td>
<td>8.5</td>
<td>5.6</td>
<td>5.1</td>
<td>10.3</td>
<td>7.9</td>
<td>12.7</td>
<td>12.2</td>
</tr>
<tr>
<td>Change in reserves</td>
<td>-2.1</td>
<td>-29.7</td>
<td>-39.8</td>
<td>-33</td>
<td>-49.1</td>
<td>-12.1</td>
<td>-7.3</td>
<td>-8.9</td>
</tr>
</tbody>
</table>


Table 13: Net capital flows to Latin America
It is now generally accepted among observers of varying ideological and analytical persuasion, that this is not a tendency that will quickly reverse itself. Even the IMF, generally the last multilateral economic institution to accept any unpleasant reality, has conceded in its *World Economic Outlook* (1998) that there is a real risk is that the recent panic may fail to subside for some time. This is likely to imply significant net outflows of foreign capital from many economies, as already witnessed in the Asian crisis countries and in Russia. The growing fear and insecurity among market participants, which is reflected in the large yield spreads seen recently, could become self-fulfilling and result in the prolonged disruption of international financial flows with severely depressing effects on economic activity as well as on world trade.

What is important to note here is that the crisis - in the specific form of dramatic reduction in net capital inflows - is currently attacking virtually all emerging markets, not simply those which have been identified as having specific domestic problems or which are perceived as particularly risky prospects. This is essentially a repetition of a historical pattern in international
lending and portfolio investment which can be traced over more than a century, whereby problems of repayment or potential default in one recipient country have led to dramatic declines in all such inflows to all developing countries, rather than being confined to the individual transgressor. International lending to developing countries has always been characterised by such cycles, and sharp collapses in such flows consequent upon repayment problems of a small sub-group of debtors, are evident in the 1920s, 1930s, and of course in the external debt crisis of the 1980s. (Kindleberger, 1986; Eichengreen, 1993) The current talk of "contagion" as if it were a qualitatively new market phenomenon misses this obvious historical point. It has typically been in the nature of private international capital to move in such a manner, and the current expansion of global finance has only accentuated such a tendency.

The immediate impact of the Southeast Asian crisis and its subsequent spread to Russia and Latin America has been a deceleration in global output growth, from 4 per cent in 1997 to an estimated 2 per cent in 1998. Interestingly, this decline has been almost wholly due to the decline in growth in Japan and the non-OECD countries, while the United States and the EU have registered creditable rates of growth even in 1998. In fact, the United States ended 1998 with a robust last quarter annualised growth rate of 5.6 per cent.

However, as the OECD reports, developments since the middle of 1998 have given cause for concern even in the United States and the EU. In response to this the United States Fed has reduced interest rates in three steps by 0.75 of a percentage point. US manufacturers have been crying hoarse about unfair competition in industries like steel, prompting the government to hold out threats of imposing protectionist “anti-dumping” duties. But what has kept the United States’ economy booming is the boom in its stock markets, which benefits from the flight to safety of capital from emerging markets and elsewhere.

Table 15: Output growth: actuals and projections

<table>
<thead>
<tr>
<th>Percentage Increase in Real GDP Over Previous Period</th>
<th>Projections</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1997</td>
</tr>
<tr>
<td>US</td>
<td>3.9</td>
</tr>
<tr>
<td>Japan</td>
<td>0.8</td>
</tr>
<tr>
<td>EU</td>
<td>2.7</td>
</tr>
<tr>
<td>OECD</td>
<td>3.2</td>
</tr>
<tr>
<td>Non-OECD</td>
<td>5</td>
</tr>
<tr>
<td>World</td>
<td>4</td>
</tr>
</tbody>
</table>


The slowdown in world growth is reflected in a slowdown of world trade growth as well. The rate of growth of the volume of world merchandise trade in general and manufactures trade in
particular is expected to more than halve in 1998 and remain at relatively low levels over the next two years. While export growth is expected to decline in both the OECD and non-OECD area, imports into the non-OECD countries is estimated to shrink by 2.1 per cent in 1998 because of the severe recession affecting most of these economies. This could trigger protectionist tendencies in the United States and EU, leading to trade wars of the kind exemplified by the almost comical battle over the trade in bananas.

One consequence of the slowdown in world output and trade growth has been a collapse of commodity prices. For the trade transactions of developing countries this was a mixed blessing. First, it implied a major loss of export revenues from the export of primary products, aggravating the contraction in many non-OECD countries. Second, in as much as the collapse in commodity prices involves a collapse in oil prices as well, which are 30 per cent below their 1997 average level. This, by reducing the oil import bill of many developing countries, helps shore up their trade balance. Third, however, the fall in oil prices threatens remittance flows from migrants to the Gulf from a number of developing countries like India, weakening their current account.

Given the adverse consequences of the slowdown of world trade for export revenues in general, it is now clear that the aggregate effect of the fall in commodity prices on current balances in developing countries is adverse, except in cases where severe domestic recession helps curb the growth of non-oil imports as well. The latter experience is epitomised by the East Asian economies. The Republic of Korea’s current account deficit of $8.2 billion in 1997 has turned into a current account surplus of $37.6 billion in 1998, amounting to 12.5 per cent of GDP. In four other crisis stricken Asian countries (Indonesia, Philippines, Malaysia and Thailand) a current account deficit of $16.5 billion in 1997 has been transformed into a current account surplus of $28.5 billion in 1998.

Table 16: Merchandise trade volume growth

<table>
<thead>
<tr>
<th></th>
<th>Percentage Change Over Previous Period</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1997</td>
</tr>
<tr>
<td>World Trade</td>
<td>9.8</td>
</tr>
<tr>
<td>of which: Manf</td>
<td>11.4</td>
</tr>
<tr>
<td>OECD Exp.</td>
<td>11.3</td>
</tr>
<tr>
<td>OECD Imp.</td>
<td>9.9</td>
</tr>
<tr>
<td>Non-OECD Exp</td>
<td>7.6</td>
</tr>
<tr>
<td>Non-OECD Imp</td>
<td>7.7</td>
</tr>
</tbody>
</table>

Source: OECD, Economic Outlook, December 1998, Paris: OECD
While a recession-driven contraction in imports dominantly accounts for this dramatic transition from a current account deficit to a large surplus, a pick up in exports has also played a role. For developing countries the ramifications go beyond the loss of access to international liquidity. Given the massive devaluation of East Asian currencies, and the desperation of these countries to push out exports to deal with severe domestic deflation, other developing countries are facing intense competition in world markets. They are not always in a position to deal with such competition with competitive devaluation. Since financial liberalization and exposure to international capital flows imply that the effort could set off expectations which lead to an uncontrollable slide in currencies, governments find it difficult to manoeuvre currencies downwards to meet the competition.

The recession in the East Asian economies and the massive depreciation of their currencies is likely to influence the pattern of FDI flows to developing countries as well. One reason for this is the role of exchange rates in influencing decisions on relocative FDI flows seeking competitive locations for world market production. The role of exchange rates in the direct investment process is an extension of their influence on trade as conventionally presented in textbooks. A country with a strong currency finds that its exports are less competitive, while imports are cheaper, than in a situation where the value of its currency relative to competing nations was lower. Individual firms in the country interested in retaining their competitiveness in domestic and export markets would, in the wake of currency appreciation, constantly be examining the losses they incur by reducing prices in domestic currency units in order to remain competitive. At some point these actual or potential losses drive firms to relocate production capacity in environments where exchange rates are such that the domestic currency value is low relative to its own currency.

Underlying, though not determining, such exchange rate movements are of course balance of payments trends. This could mean that a country with a "competitive" exchange rate which attracts relocative FDI and increases its exports to the world market, soon builds up current account surpluses, that strengthens the value of its currency. That is, as in the case of cost "advantages", those stemming from a "competitive" exchange rate could also prove transient, resulting in the expectation that if the tendency towards relocative FDI is driven by cost or exchange rate differentials, it would result in a gradual spread of industrial capacity to new locations. For individual firms, this implies that the economic success of a nation reflected in a strong current account and accumulating foreign exchange surpluses would soon take the exchange rate to levels where some of the activities that were earlier competitive are best relocated elsewhere. This "push" from within investor countries or from within "traditional" sites for relocation is the other fallout of the wave of liberalization during the 1970s and 1980s which had financial and exchange rate deregulation as important components.

This is not to say that there would be no outflow of foreign direct investment from countries with depreciating currencies. Such outflows could either be reflective of the old form of FDI seeking to cater to host-country markets, or of fact that stimuli other than currency values dominate the relocation choice. What needs to be noted is that, unlike protection in host country markets which stimulates relocation of capacity aimed at that market alone, high and rising wage costs and/or strong currencies in developed and newly-industrialised as opposed to developing
countries are more generalised stimuli to relocation. If the cumulative effect of such factors are substantial, then any exporting enterprise, which does not meet the consequent loss of competitive advantage through relocation to new sites, faces the threat of exit from areas of activity in which it has historically had a significant presence. In the event, capacity is "pushed" or "pulled" out from traditional locations, resulting in a flow of foreign direct investment driven by the need to relocate capacity to new sites of production.

Such exchange rate driven trends played a crucial role in outflows of capital from the first-tier NIEs to the second tier NIEs in the ASEAN region, and more recently to Vietnam, Cambodia and even India. If we examine the evidence in the case of individual Asian countries, we find that: (i) by the early 1980s itself many of the newly industrialising economies were recording a substantial decline in net inflows because they were becoming significant foreign investors abroad; and (ii) by the late 1980s, not only had some of these NIEs turned net exporters of foreign direct investment capital but the decline in net inflows had come to characterise some of the ASEAN countries as well. As of 1993, over 50 per cent of the total value of the stock of foreign direct investment in East and Southeast Asia originated from within the Asian region. (ADB 1996) In fact the major source of that investment was the group of Asian NIEs and not Japan.13

With the crisis having led to a collapse of exchange rates in the first and second tier NIEs, one can expect that outflow of capital from these economies would slow, and that they would now once again emerge as competitive locations for FDI. This could mean that countries expecting to benefit from the spread of relocative FDI to new locations and are attempting to woo foreign investors may not be successful in their effort.

But that is not all. The combination of deflation which has resulted in a collapse in asset values in these economies and massive currency depreciation which takes the dollar value of those assets to rock bottom levels, has set off a virtual bargain hunt for assets in East Asia. According to IFR Securities Data, non-Asian buyers spent $6.52 billion in the second quarter of 1998 on deals in Japan, the Republic of Korea, Hong Kong, Malaysia, Thailand and Indonesia. This furthered an upward trend since the third quarter of 1997, when the total was only $680m. Deals in the fourth quarter of 1997 reportedly fell just short of $3 billion, rising to about $5.5 billion in the first quarter of 1998. The Republic of Korea and Japan accounted for most of this increase in the value of takeovers.

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13 However, the total for the Asian NIEs is dominated by Hong Kong into the People's Republic of China, and needs to be read with caution. Between 1991 and 1993 China moved from rank 13 among all FDI recipients, developing and developed, to the second ranking country after the United States. Subsequently, while the annual increase in FDI inflows has fallen from 147 per cent in 1993 to 14 per cent in 1994 and an estimated 11 per cent in 1995, growth has been positive relative to the remarkably high levels they had already reached. Besides the sheer quantum there are some other features which are exceptional in the Chinese case: (i) About 70 per cent of FDI flows are "in kind", that is in terms of equipment and technology whose value is matched with other domestic "kind" investments like land and building to determine foreign and domestic share; (ii) A part of this investment is due to an initial outflow of capital from China which is rerouted through Hong Kong based companies back to the country, to take advantage of the excessively favourable terms offered to foreign investor firms; (iii) Hong Kong, Macau and Taiwan, China PoC dominate FDI flows into the country, with FDI flows from these sources accounting for 72 per cent of cumulative flows in 1993 and an estimated 63 per cent in 1995.
These factors point to a substantial degree of "overestimation" of FDI flows to China for two reasons: first, a tendency to overvalue capital equipment inflows in order to raise the value and share of foreign investment in kind; second, a possible outflow of domestic capital to neighbouring regions from where they return as foreign direct investment in order to obtain the special concessions provided to foreign investors. These factors, together with the return of Hong Kong to China in 1997 and the special relationship that foreign-exchange-surplus Taiwan, China had to maintain with it for historical reasons, suggest that the unprecedented boom could give way. Indeed there is already evidence of a decline in FDI inflows into China in the current year, along with a decline in GDP.

6. Policy implications for India

It is in this background that we have to assess the policy implications for India. The overarching implication is of course that the threat of deflation, driven by a financial crisis is real. In fact, once integration with globalised finance proceeds beyond a point, the state of a country, as reflected by its GDP growth or inflation rate, or even the size of its foreign exchange reserves, need not be adequate to predict an imminent crisis. East Asian economies had performed very differently in the period immediately preceding the crisis, and Brazil despite "qualifying" for a $42 billion IMF package, could not stave off the Real crisis. Thus policy in the current period should not be directed merely at keeping investors, particularly financial investors happy, but partly at insulating the system from external shocks.

The second lesson is that a slump in export growth in economies which are increasingly more integrated into the world trading system is a major danger signal. This makes the collapse in India's exports in recent quarters a reason not merely to proceed with caution, but in fact to even retract on elements of liberalization that exceed the requirements set by her membership in the WTO. It could of course be argued that India's poor export performance is more related to the slowing of world trade growth than was true of the East Asian economies, and that the crisis in East Asia itself has played a role in undermining India's export competitiveness. But these arguments only go to prove that the world economic scenario currently is least propitious from the point of view of launching on an accelerated pace of external reform.

Since the slowing of export growth and a widening of the trade and current account deficits are important catalyst for a collapse of investor confidence, they call for measures to insulate the system against a currency crisis as well. This makes the task of exchange rate management extremely difficult. With the introduction of the unified exchange rate system, the only means by which the Reserve Bank of India can influence the exchange rate is through open market operations. In periods when large portfolio and debt inflows result in a tendency in the market for the rupee to appreciate, the RBI is forced through open market purchases to acquire large

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14 These factors point to a substantial degree of “overestimation” of FDI flows to China for two reasons: first, a tendency to overvalue capital equipment inflows in order to raise the value and share of foreign investment in kind; second, a possible outflow of domestic capital to neighbouring regions from where they return as foreign direct investment in order to obtain the special concessions provided to foreign investors. These factors, together with the return of Hong Kong to China in 1997 and the special relationship that foreign-exchange-surplus Taiwan, China had to maintain with it for historical reasons, suggest that the unprecedented boom could give way. Indeed there is already evidence of a decline in FDI inflows into China in the current year, along with a decline in GDP.
volumes of foreign exchange and increase the size of its reserves. This is exactly what happened
during the mid-1990s. Those reserves once accumulated are however difficult to run down, since
they are an important determinant of the confidence in the rupee. As the East Asian experience
indicates, a reserve amounting $25-30 billion is small change if there is a run on the rupee because
of a loss of confidence which can arise from a number of factors. This makes burgeoning reserves
acquired often at high interest rates and parked as short term funds at extremely low interest, a
partial indicator of economic strength.

Being unable to run down reserves without affecting confidence implies that an effort to
respond to the loss of competitiveness in the wake of the massive depreciation of the currencies of
competitors from East Asia, by managing a depreciation of the rupee, is near impossible. Once the
RBI, through dollar sales allows the rupee to depreciate in value, expectations of a further
depreciation arise, since the extent of devaluation need to restore competitiveness is indeed large.
Even though India has not yet opted for capital account convertibility, there are a number of ways
in which speculators can operate on the basis of such expectation. Exporters can choose to delay
the repatriation of their export proceeds. Non-residents and foreign institutional investors can
hold back on making new deposits and investments as well as repatriate part of their current
holdings to forestall losses or capture gains in the wake of a depreciation. And authorised dealers
can make short-term (even overnight) acquisitions of the dollar in the hope of booking profits.
This is precisely what happened in late 1998 when the RBI chose to experiment with a dose of
managed devaluation. The net result of this danger is that while India's exports languish, the rupee
remains relatively strong, with periods of even real, effective appreciation.

One implication of this experience is that India just cannot contemplate any further
liberalization of its exchange rate regime. What it possibly needs to do is tighten controls, through
a higher rate of capital gains taxation, than the prevalent 10 per cent, on early repatriation of
funds invested in the stock market by non-residents and foreign institutional investors. This need
not imply much more inflexibility, but it would mean greater instruments in the hands of the RBI
to control the level of the exchange rate to some extent. It also means that there would be some
control on capital inflows as much as outflows, the necessity of which has been emphasised by the
Southeast Asian experience.

Above all, India needs to think of alternative means of pushing out exports then merely
relying on the (price) exchange rate mechanism as a driver of export growth. This means that the
export strategy should be strategic in nature, and provide special incentives to those areas of
export growth which have either the most potential for employment generation or which imply a
significant increase in domestic value added.

External vulnerability of this kind has implications for macroeconomic and monetary
management as well. If the central bank is saddled with large increases in its foreign assets, money
supply can be controlled only by a process of sterilisation involving a reduction in central bank
credit. The principal area in which such reduction occurs is with regard to central bank credit to
the government. This has two implications. First, it substantially reduces the fiscal vulnerability of
the state, reducing its capability (as shown in the first section of this paper) to stimulate growth,
sustain welfare measures like subsidies and increase outlays on the social sectors like health,
education and those aiming to meet the basic needs of the population. Secondly, with the State
caught in a fiscal wrench, the only means of macroeconomic management is monetary policy. Here, however, the fiscal crunch forces the government to turn to the open market for even the minimum volume of borrowings it undertakes. In periods when demand for credit from the private sector is also high, as was the case during the mid 1990s industrial boom, this leads to high interest rates. It is only when a recession induced reduction in the private sector's demand for credit eases monetary stringency that the government can manoeuvre interest rates downwards, as has happened recently.

This situation where a reduction in interest rates is a means of stimulating recovery, but where recovery inevitably leads to higher interest rates, reduces the efficacy of monetary policy as means to stimulate growth. Given the higher reliance of employment-intensive small industries in particular on bank credit rather than other means of raising capital, it is important to ensure that monetary policy does not become a constraint on productive activity. While this does not mean that interest rates must be completely administered, it does suggest that as far as possible the monetary and credit policy of the government should be designed towards the expansion of production and employment.

There is a perception that external vulnerability is essentially a consequence of dependence on purely financial flows, but that flows of foreign direct investment help improve the balance of payments situation. This is based on the presumption that FDI flows are of the relocative kind, in whose case there is a virtuous nexus between such inflows and exports. However, import liberalization and the liberalization of foreign investment regulation in economies with home markets of a significant size inevitably encourages FDI directed at the domestic market. In fact, in India liberalization has encouraged three kinds of FDI flows. First, is a set of flows by transnationals who already control assets in the domestic economy who, in the wake of liberalization permitting a higher share of foreign equity in foreign controlled rupee companies, choose to enhance their equity stake with relatively small dollar investments. These small investments substantially increase their ability to repatriate dividends from future profits. Second, investments by foreign firms which virtually purchase large domestic market shares by fully or partially acquiring domestic firms that dominate particular markets. The acquisition of Parle Exports, which dominated the soft drinks market, by Coca Cola and the partial acquisition of the Malhotra's blade empire are instances of these. Finally, there is a large inflow into the non-tradable, infrastructural sector, attracted by special concessions, including guaranteed returns, offered by the government for such investments.

It should be clear that in all these cases the initial inflow of investment would be followed by large and persistent outflows on account of imports, royalties, technical fees and dividends, with adverse balance of payments consequences. With the rush for purchase of East Asian assets rendered cheap by deflated prices and depreciated currencies, which we have discussed above, it is even more unlikely that relocative FDI geared to export production would flow to countries like India. Hence rather than liberalise FDI policy across the board, the government should seek to provide special incentives for FDI which uses the country as a location for world market production and to discourage flows that bring little by way of technology but are costly in foreign exchange terms. Such aims mean that uniform rules for all FDI are not the most appropriate; rather, instead of an omnibus policy towards all FDI, the government should seek to provide
fiscal, locational and infrastructural incentives to those forms of FDI which are seen as furthering the overall strategy of industrialisation. Other FDI flows need not be accorded any such special treatment. In this context it is worth noting that certain elements of the TRIMS agreement under the Uruguay Round of GATT and of the proposed Multilateral Investment Agreement which is sought to be included in the Millennium Round need to be reconsidered and appropriately interpreted by developing countries.

These features of global and domestic trade scenario imply that despite new trends in FDI, post-reform Indian economic growth is accompanied by persisting external vulnerability. The significance of this phenomenon, however, is not that there is no option but succumb to this heightened vulnerability and hope for the best, but to work out a national economic policy that takes this vulnerability into account. Reduced manoeuvrability does by no means imply no manoeuvrability at all.

However, reduced vulnerability does imply that the kind of developmental agenda that was worked out in the immediate post-War years is no longer adequate. Developing countries cannot return to a strategy of making optimum use of "available" foreign exchange earnings, through import-substitution strategies of the kind that the Feldman-Mahalanobis model epitomised. Such strategies attempted to control the rate of growth and degree of diversification of consumption, on the one hand, and reduce dependence on manufactured imports in the long run, by utilising scarce foreign exchange to create a capital goods sector, in general, and a machine tools sector in particular.

However, the problem with that strategy was three-fold. Firstly, it was really open only to developing countries which in terms of size of the domestic market and resource base were above a critical minimum. Secondly, even in the case of these countries, since the growth of manufactured goods production was determined by the scale and quality requirements of the domestic market, an increase in the ability to produce manufactures was not necessarily accompanied by an increase in the ability to keep pace with international innovations and export manufactures, holding back the rate of expansion of the system in the long run. Finally, given the inequalities within the system and the growing pressures from the well-to-do to obtain access to product innovations that defined international lifestyles to which they were inevitably exposed, the ability of the State to restrict the rate of growth and degree of diversification of consumption was increasingly undermined. Neither the savings rate nor the import-intensity of domestic productions stuck to the trajectory that the strategy charted. Given the parameters within which it operated and the concept of development that it implicitly appropriated, import-substitution was doomed to failure. Thus the alternative we need to consider must go beyond the dirigisme characteristic of "old-style import substitution", even while retaining its principal objective, viz., that of reducing external vulnerability. This is all the more true since the nature of external vulnerability appears transformed in a world dominated by fluid finance capital.

This brings us to the first aspect of the alternative strategy incorporating intervention: it must transcend the dichotomy between production for the domestic market and production for export. In its archetypal form that dichotomy is reflected in arguments that make a case for industrialisation based on the home market because international inequality provides grounds for 'export pessimism'. In the debate on the transition to capitalism that led up to the industrial
revolution, one issue of contention was the relative roles of purely 'internal' factors in the form of structural change, as opposed to 'external' factors like the effects of commercialisation and the growth of markets in determining that transition. Whatever the merits of those contending arguments with regard to the principal determinant, one thing appears clear with hindsight. Successful capitalist industrialisation cannot occur in a context "insulated" from world markets, but requires consciously engaging those markets as part of the strategy of growth.

We use the term "engaging" advisedly. World markets are not benign, autonomous forces that spur efficient Third World industrialisation. On the contrary they embody all the inequalities characteristic of the world system. Engaging those markets involves therefore using all the weaponry in the hands of a developing country, including the power of its State, the foundation that its home market provides, the ability of its scientific and technical personnel to override the domination implied in the control of technology by a few transnational firms and the advantages of the late entrant (varying from low wages to a less codified legal framework), to prise open those markets that inequality suggests are hermetically sealed for them.

It also implies that, especially for countries with a potentially large domestic market, domestic capital must be provided with both time and space to achieve the level of competitiveness that are required to face up to international competition. This suggests a strategy of selective and temporally phased import controls, which while allowing access to crucial capital goods, raw materials and intermediates, provides a degree of space for domestic production of a range of final goods. There are two obvious corollaries of this. First, in the sequencing of import liberalization, the liberalization of imports of consumer goods should come last and with some delay. Second, the import tariff structure needs to be such, especially for capital goods, that negative protection is avoided.

This brings us to our second point. A successful growth strategy has to be based on an activist State. There is no relationship between the existence of an activist State and autarky or, for that matter, insularity. One valid criticism of the import substitution years in countries like India is that it neglected exports. While exports cannot constitute a basis for growth in a large developing country, in an interdependent world one cannot finance the imports that accompany the process of growth without an export thrust. It is for this reason that all successful late industrialisers, including the so-called NIEs, had pursued a "mercantilist" export policy which emphasises pushing out exports at whatever cost. Such a policy involves a continuous restructuring of the production base of the system in both quantitative and qualitative terms, which requires both technology and investment. Investment matters for two reasons: first, the larger the size of investment the larger the share that can be devoted to modernisation as opposed to 'expansion'; second, since for any incremental capital output ratio, higher investment implies higher growth, capacity expansion proceeds at a pace that allows the incorporation of new technology at the margin. For these and other reasons, the rate of growth of manufacturing exports of an economy is dependent on the investment ratio.

Development economics in the early years singled out investment as the key to growth. In fact the group of highly-distinguished development economists headed by Arthur Lewis who authored the well-known Measures document of the United Nations (1951) made raising the investment ratio the cornerstone of their recommendations for development in the underdeveloped
countries. The emphasis shifted only with the neo-classical critique of the late sixties\textsuperscript{15}. It was the \textit{efficiency of resource use}, as emphasised by neo-classical writers, which gradually came to occupy centre-stage; what mattered, according to this perception then, is the \textit{economic regime} within which development took place, whether or not this \textit{regime} was conducive to the achievement of efficiency of resource use. What a regime conducive to such efficiency on the neo-classical argument would do to the investment ratio was never discussed, a reflection essentially of a shift of attention from the macro to the micro issues underlying the development process (and of course to a "marketist" stance in this micro discussion). In short, the investment ratio dropped out of the picture as a significant phenomenon to concentrate attention upon.

More recently, however, a range of writings from authors of rather widely differing persuasions \textsuperscript{16} has argued that the successful cases of industrialisation in East Asia was largely explained by an increase in factor inputs into the production process, including capital inputs in the form of high rates of capital accumulation. That is, it is not greater efficiency of resource use \textit{per se}, but larger outlays of inputs at a given level of efficiency that explains success. At one level this argument is supported by evidence on cross-country Total Factor Productivity (TFP) growth estimates using purchasing power parity data, which suggests that over 1970-85 "productivity" in the Republic of Korea, Taiwan, China, Singapore and Hong Kong grew much slower than Egypt, Pakistan or even Bangladesh. \textsuperscript{17} However, the TFP index, favoured normally by the World Bank, is based on assumptions such as full employment of resources and perfect competition, rendering it inadequate for real world analysis.

A more useful way of analysing the phenomenon is to undertake cross-country correlations of investment ratios, output growth rates and export growth rates. An analysis \textsuperscript{18} based on twenty years (1968-88) data for 25 developing countries showed a close correlation between output growth and the investment rate (or the ratio of investment to income). Similarly there was an extremely close relationship between output growth and export growth. If it is investment which drives output growth then the high correlation between output growth and export growth must make itself visible in terms of a high correlation between investment ratio and export growth, which it does.

There are good theoretical reasons why a high investment ratio \textit{ceteris paribus} should give rise to a strong export growth performance. International trade in the different commodities grows, over any period, at different rates. Given these growth rates in world trade, the rate at which a particular underdeveloped country's exports grow would depend to a very significant extent upon its production-structure and the rate at which this structure is changing. In particular since the underdeveloped countries are, by and large, saddled with production-structures

\textsuperscript{15}The neo-classical critique was elaborated among other places in Little, Scitovsky and Scott [1970].

\textsuperscript{16}See, for example, Krugman 1994; Akyuz and Gore 1994; Singh 1995.

\textsuperscript{17}Young 1994.

\textsuperscript{18}See Patnaik & Chandrasekhar 1996.
specialising in commodities with relatively stagnant world trade, success on the export front depends crucially upon the ability to transform the production-structure rapidly in the direction of commodities where world trade grows faster. And the rapidity of this transformation is linked to the investment ratio: the higher the investment ratio, the faster the transformation of the production-structure and hence the greater the ability to participate in the faster-growing end of the world trade, i.e. the greater the rate of export growth.

An activist State is needed not merely to raise investment rates, but to coordinate the export thrust. The evidence from east Asia suggests that such coordination was crucial, because a mercantilist industrial policy rather than market determined comparative advantage was crucial in establishing a foothold in international markets. \(^{19}\)

There is enough evidence that countries like the Republic of Korea and Taiwan, China pursued similar strategic and anticipatory industrial policies as a run up to their competitive success. Hence, even when a high investment rate is realised through the agency of private entrepreneurs, the government needs to ensure that an adequate share of such investment is allocated to sectors selectively chosen as thrust areas for exports and embodied in technologies and plant scales that enhance international competitiveness. During the import-substitution years when the thrust of policy was to build a domestic industrial base using the economic space provided by a protected market, state policy was largely directed at regulating the adverse consequences - in the form of concentration, monopolistic pricing, uneconomic scales and a skewed production pattern - of inadequate competition or rivalry. Many of these problems are now being directly dealt with by the "cutting edge" of international competition in a more liberalised world. However, openness and competition alone do not guarantee export success, as a range of experiences have shown. Some degree of intervention by the State seems necessary. But that intervention has now to take on a new form, with the emphasis on matching microeconomic investment decision-making with a coordinated or "planned" export thrust.

An important instrument in realising the objectives of this new form of intervention is monetary policy. The evidence seems to suggest that interest rate differentials and are a useful instrument for realising an export thrust of the kind described above. This automatically suggests that financial liberalization of a kind that does not permit such differentials, and weak banking systems in which such policies can be misused need to be reformed, with the imposition of capital adequacy norms and transparent procedures. Such policies also imply some degree of sequencing of any process of "liberalization" aimed at dismantling structures characteristic of the earlier import-substituting strategy. Industrial liberalization (of licensing laws, output controls and direct

\(^{19}\)For example, Vice-Minister Ojmi of Japan's Ministry of International Trade and Industry is reported to have summed up Japan's industrial policy perspective as follows: "The MITI decided to establish in Japan industries which require intensive employment of capital and technology, industries that in consideration of comparative cost of production should be the most inappropriate for Japan, industries such as steel, oil-refining, petrochemicals, automobiles, aircraft, industrial machinery of all sorts, and electronics, including electronic computers. From a short run static viewpoint, encouragement of such industries would seem to conflict with economic rationalism. But, from a long-range viewpoint, these are precisely the industries where income elasticity of demand is high, technological progress is rapid, and labour productivity rises fast." Quoted in Singh [1995].
price controls) must take precedence over trade liberalization, and both of them over the liberalization of the financial sector. For all these reasons, coordination by the government is crucial.

Activism of this kind has as its corollary two features. First, an activist State pursuing a mercantilist growth strategy should be in a position to discipline its industrial class. Second, activism requires the mobilisation of adequate resources by the State to sustain that strategy. The need to discipline the industrial class arises because, even while departing from the detailed physical controls characteristic of the import substitution years, the strategy being elaborated here requires a substantial degree of strategic targeting and coordination by the State. Through incentives, on the one hand, and measures to enforce compliance, on the other, the government must be in a position to influence investment decision-making at a microeconomic level. Based on the segment of the world market that is being targeted, the coordinating agency should be able to influence the choice of product, technology, scale of production and price.

Needless to say, imposing such discipline requires the backing of other sections of society, which defines the third prong of an alternative strategy. Social support for a strong State is most often won in a situation where land reforms have dismantled structures that provide the base for a collusive elite. The vital necessity of land reforms is underscored by the fact that even the successful east Asian capitalist economies owe their success inter alia to the post-war land reforms that they had.

But land reforms are needed not merely as an instrument of mobilising political support. A thrust towards land redistribution and greater social expenditures in the rural areas which are best undertaken under the aegis of directly elected decentralised governing bodies (e.g. the panchayats in India), is essential also for widening the home market immediately, ensuring a rapid increase in agricultural output (as has happened in West Bengal, India, for example), and increasing the potential for direct and indirect employment generation. To that end land reforms would have to be accompanied by investments in the agricultural sector - in irrigation and water management and other kinds of rural infrastructure - that permit an acceleration of industrial growth. Typically such institutional changes are also associated with increasing employment, so that the overall employment generation in the economy increases as a result, especially relative to an alternative trajectory. This would not only broaden the base of development but also create decision making structures through devolution that are crucial for generating the strength and the accountability needed to make the State capable of functioning as a disciplining force.

Globalisation is fundamentally a centralising tendency, drawing disparate economies and sectors into the vortex of a world controlled by a few decision makers. It also replicates this centralisation in economies which it integrates into the world system, creating strong domestic interests that support the case for an open economy and a marketist strategy. The suggestion that the nation state is no more a meaningful category comes from those who find in an "integrationist" strategy greater economic benefit than from any strategy of reserving domestic space for domestic interests, so that some forces that advocated protection and state intervention

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in the 1950s, now support a liberal economic regime. The problem however is such a regime marginalises the disadvantaged, who constitute a majority in most developing countries - a majority which because of centralisation cannot make the case that the attenuation of the nation state challenges their already meagre standards of living. This however offers an opportunity to forces seeking an alternative to blind marketism. They constitute the social base which can legitimise the effort to reckon with the adverse consequences of globalisation. This implies that political and economic decision-making needs to be decentralised so that segments who believe that there must be an alternative to unbridled marketism can find a voice. It also means that any alternative strategy must immediately address their basic needs so as to consolidate their support for that alternative.

Thus an alternative growth strategy does involve economic "reforms", though not of the kind dictated by the Fund and the Bank to all developing countries. The objective of the reforms must be to widen the home market, to provide the broadest possible basis for development through appropriate structural change. But broadening of the market without a stimulus for its expansion can be counterproductive. And a State faced with macroeconomic disequilibria is hardly in a position to provide that stimulus. This implies that macroeconomic disequilibrium reflected in high budget deficits, has to be corrected through direct taxation and a reduction in inessential expenditure. Through greater discipline in tax-enforcement, changes in tax laws, removing certain kinds of exemptions, and an adjustment of rates for top income brackets, the revenue from income taxation should increase.

With greater resort to direct taxation, the tendency towards garnering revenue from indirect taxes and administered price-hikes would have been reversed which itself would be an anti-inflationary measure. Even so however it is also necessary in addition to protect the poor from the effects of such inflation as would occur. And this is best done through an extension of the public distribution system, both geographically into the rural areas as well as in terms of its commodity coverage. To keep the strain on the exchequer of such an extension of the public distribution system within reasonable limits, there should be an adjustment in the targeting of this system, towards the poor.

The other component of macroeconomic disequilibrium which plagues developing countries like India, viz. the deficit on the current account of the balance of payments, is dealt with more directly in the strategy being proposed. The growth of income and exports here are not made dependent on the pursuit of an open economic regime, but are a fallout of the activism of the State. This implies that the combination of selective but stringent import controls and an export thrust itself provides the basis for a correction of balance of payments disequilibria. Further, growth in a broad-based development strategy is not dependent on access to international finance, but uses the foothold offered in part by the home market. This implies that even the direct link between growth and vulnerability, or dependence on 'hot money' flows is snapped, achieving the principal objective of the alternative traverse.

The important feature of this package is that its focus on the expansion of the domestic market implies emphasising employment generation and the provision of adequate and sustainable livelihoods to the population. It should be noted that production for the mass market for manufactures tends to involve goods which have a higher labour intensity of production than the
production of luxury goods. All of these issues are especially important not only because of the obvious welfare and equity implications, but because, in the absence of such development, the political and social tensions unleashed by the inequalising effects of globalisation are likely to become very difficult to contain. 21

Thus a package of policies of this kind would not merely help accelerate growth with some attention to equity, but would break the nexus between even a minimal rate of growth and an acceleration of dependence on foreign finance. Any access to finance would essentially serve to raise the rate of growth beyond that critical minimum, which is not subject to the uncertainties that the external vulnerability stemming from dependence on international capital generates. It is thus that the "opportunity" offered by the rise to dominance of finance capital can be used by a developing country to engage international markets. That is the virtuous circle that commends itself in the new environment is one in which an effort by an activist State to engage international markets for goods and services provides it with the foundations needed to engage international capital markets and use them as one more weapon to further prise open unequal international markets.

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21 This point is now recognised even by mainstream political economists such as Dani Rodrik (1999) who have pointed out that a general political movement against globalisation may be the result of not taking into account more seriously, the social consequences of globalisation.
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