THE ECONOMIC CRISIS IN INDIA

by

Wilfred Malenbaum

Center for International Studies
Massachusetts Institute of Technology
Cambridge, Massachusetts
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Conclusions:

1. Indian economic growth under the Second Plan, now entering its second year, is faltering. It is not likely that the economy can attain its development targets in 1960/61 unless rapid and significant actions—not now contemplated, as far as I know—are taken both by the Government of India and by foreign financing institutions. The crisis is dramatized in the deteriorated foreign exchange position of the country. This is of key importance, but it is only a manifestation of the basic problems involved in the attempt at a rapid acceleration of the rate of economic growth.

2. A significant short-fall in Indian achievement would constitute a setback to United States policy in Asia and perhaps equally in Africa. World publicity attaches to the fact that India is attempting rapid economic progress while retaining a high level of the individual freedoms prized by a democratic society. There are clear and obvious contrasts with the development plans of Communist China, particularly in the eyes of the peoples of Asia and Africa. Moreover, there is truth in the fact that failure to achieve planned targets in India arises in part from the deep-rooted attitudes of the government leadership favoring a relatively free non-controlled economic order.

3. The feeling is growing among Indian leaders (vocalized to date primarily by spokesmen for the private sector) that the best tactics to meet the current crisis is a quick and orderly retreat. Plan targets, they argue, should be delayed beyond 1960/61, perhaps for as much as three years. This
course constitutes an admission of defeat, and its effects, in India and abroad, would not be significantly different from those mentioned above. Moreover, such counsel seems to be influenced principally by the foreign exchange crisis. While the extension of the Plan would serve to mitigate this crisis, it does not in itself solve other more basic problems of the development program. At the present time, targets for 1960/61 should not be lowered.

4. On the other hand, the Indian crisis does warrant the quick shot-in-the-arm remedy that an increased availability of foreign exchange will provide. It is essential that this initial step be followed by other actions, and particularly by actions bearing upon the level and flow of domestic savings and investment. There is every reason to expect that some combination of immediate and longer run steps can still yield levels of overall achievement by 1960/61 in line with the targets popularly accepted for that date.

5. The Government of India should be assured at once that India can count upon $1000 million in additional resources during the period ending March 31, 1961, for use in programs mutually satisfactory to India and donor nations or institutions (e.g., the IBRD). Some part of this, say $150 million, should be made available at once for immediate purchases, listed in the Plan, of capital goods for the public sector. Simultaneously discussions should begin, preferably by an international group of qualified persons, on how the additional amounts could be used in the Indian development program and what steps are needed to assure the economic growth India seeks.
Argument:

6. At least three basic factors contribute to the present Indian position. Each of them alone would have meant rough sailing for the Second Plan. Together, their effects have been marked and rapid.

(a) First is the fact that the Plan's investment estimates were low given the output targets. As steps were taken to implement specific capacity objectives in the economy, it was found that more resources were needed than were provided in the Plan. Investment expenditures were greater in both local and foreign currencies.

(b) The domestic savings and investment flows underlying the Plan appear to be unrealistic. While the Plan's domestic saving rate (an average of about 8.5 per cent of national income over the five years) is certainly a reasonable target, its achievement is made more difficult by the plan to divert a heavy flow of savings, arising primarily in the private sector, into public investment. Even with strong fiscal and other measures, the result might lower savings, and perhaps lower total output. With less effective action, the private sector, and especially agriculture and big industry, would tend to continue to invest more in their own sector.

(c) The availability of the tools notwithstanding, Government has hesitated to adopt and implement the policies and actions that are necessary for, or that would facilitate the achievement of the program. (The Government of India does not readily adopt--and implement--measures which reduce individual freedom.) Recent budgetary measures and the sharp curtailment of foreign exchange for private imports are in themselves not likely to suffice for the immediate crisis, nor do they deal with the other factors above.
(d) In addition to these, other factors should be mentioned although their importance is smaller. There is the truth that the Plan's calculations involved a foreign exchange gap for which provision was only partially made in advance. In this situation, and even assuming the Plan was operating as programmed, foreign exchange reserves would have been drawn down much more than proportionately during the first year or two. This undoubtedly explains some part of the foreign exchange phenomenon observed. Mention might also be made of India's pre-payment of the German steel loan during this period as well as of financial factors, arising from some expectancy that sterling would be de-valued, which would tend to aggravate India's payments beyond what the underlying trade and service position would warrant.

7. Examination of these factors, and their effects, points up the fact that the Plan gives to the private sector even less scope for growth than is generally realized. This is true for small scale activities, especially agriculture and other rural output; it is also true for big private industry. If targets are to be achieved over the five year period, consideration must be given to restoring some balance between public and private effort, at least in some areas.

8. On the other hand, at least the modern industry component of the private sector has demonstrated a vitality and a degree of entrepreneurial aggressiveness which are important assets in a poor country seeking to accelerate growth. This sector has been largely responsible for the crisis in foreign exchange—thus deterring public investment, for the first plan year in any case. The strong action taken by Government to alter this situation can stultify this private entrepreneurial drive. It will not serve to provide an effective balance between private and public expansion.
9. Fortunately, these weaknesses in the development structure have shown themselves at an early date. Provision for changes in allocation of resources, among other changes, can be made while still retaining the broad pattern and rates of growth of the Plan.

10. India's current foreign exchange shortage needs to be dealt with at once. At the same time, objective study of the elements of the problem can contribute to longer-range solutions and improvements. The attached sections deal more specifically, though in brief, with the problems to which study needs to be directed.
A: The Foreign-Exchange Shortage

During the Plan's first year, 1956/57, India apparently used up some Rs. 300-320 crores of foreign exchange reserves, 50 per cent more than was planned for the five years of the Second Plan. The official figures for March 31, 1956 and 1957 show a decline of about Rs. 190 crores. This, however, understates the reduction, due to a bullion re-evaluation, through which India "gained" Rs. 67 crores, and the utilization of over Rs. 60 crores of drawings from the IMF in early 1957. Preliminary analysis based upon official data for the first six months of 1956/57 (April-September) and upon incomplete data for the next quarter places the major emphasis for this decline upon the imbalance in trade and services. The annual rate of exports during this period (Rs. 577 crores) was essentially at the level mentioned in the Plan, while imports (954 crores) were appreciably ahead (by some 20 per cent). The trade imbalance was partially offset by invisible earnings which were substantially ahead of the Plan's estimates.

Contrary to expectations based on the Plan, the private sector is most responsible for this expansion in imports. Thus imports on private account alone during the first six months of 1956/57 were at an annual rate (Rs. 783 crores) at which total imports were projected. From the point of view of level of imports alone, this overfulfillment need not be too serious since Plan imports over the 5 years were phased in a very general way. Nonetheless, such a major excess of imports over the figures shown for the early years, or over the average imports forecast, should be explainable in terms of the time requirements of the Plan.

Unfortunately there is relatively little Plan information on the specific composition of these expected imports, as between public and private,
or as to their broad functional composition—capital goods, raw materials, and consumer goods. It does appear, however, that imports of consumer goods and raw materials\(^1\) were somewhat greater than was expected. With respect to the key component, capital goods, the level of imports for the first six months (an annual rate above Rs. 500 crores), imports on private account must have exceeded by far what the Plan anticipated. It is this point which is crucial in Indian foreign exchange developments over the first year of the Plan.

Net investment in the private sector over the five years was expected to be Rs. 2400 crores, of which Rs. 400 crores represented increases in stocks and Rs. 1300 crores more were to be for small-scale construction, especially housing, (Rs. 1000 crores) and for agriculture and small-scale industry (Rs. 300 crores). Investment in all these encompasses relatively little foreign capital goods. These would instead go to the rest of the private sector, to the organized industry, mining, plantations, small electric plants, etc., which were allocated an aggregate investment of Rs. 700 crores, including, of course, the provision for factory construction. It is probable that the private sector was expected to import over the 5 years some Rs. 200-250 crores of capital goods for net investment. Investment goods of this value were imported by this sector during the first 6 months of 1956/57 alone!

If we assume that replacement involves imports equivalent to what net investment in this sector requires, capital goods imports by the private sector for new investment during the first half of 1956/57 were running as much as 5 times the level anticipated on the average for the 5 Plan years. It is reasonable to assume that these large imports in the first months were not simply early

\(^1\)These figures are probably exclusive of foodgrains and other agricultural products imported on government account, such as the shipments under P. L. 480.
purchases of the requirements of the private sector for the total Plan. It therefore appears that a considerable amount of these private imports were licensed for industrial development not specifically budgeted in the Plan. (Moreover, the complementary domestic investment was presumably also not budgeted in the Plan.)

Several consequences follow from these developments:

(a) There has been some curtailment of resources that the public sector included in its investment budget, due to the overcommitments of the private sector for purposes for which provision had not been made in the Plan.

(b) The unexpectedly high level of private capital goods imports, even assuming that total capital goods imports were essentially at the level planned, accentuate the foreign exchange crisis. This follows from the fact that most of the provision made for filling the foreign exchange gap applied to imports on government account only.

(c) The heavy private composition of capital goods imports probably contributed to a larger excess import of consumer goods and raw materials than might otherwise have occurred. This stems from the fact that private investment as a whole is more urban-oriented than is public; it therefore contributed to expanded incomes in areas where expenditure propensities are higher. Also, private enterprise probably invested in facilities where the demand for raw materials followed much more rapidly upon investment than would be the case for government investment.

(d) The short-fall in government capital imports serves as a deterrent to public investment. The high levels of private investment are not compatible with the plan for public mobilization of private savings.

A further word may be in order with respect to underlying causes for
these developments. Basically, authorizations for industrial expansion and the necessary allocation of foreign exchange for imports were made with a rather open hand, and during the period when the private sector was rapidly expanding output and (in lesser degree) capacity in the 4th and 5th years of the First Plan. There is reason to believe that the general promise of the Plan, namely that the private sector could invest at a significantly higher rate than prevailed in the first Plan, was unduly optimistic, given the resource budget of the Plan. (See below, B.) Finally, neither the specific investment patterns in the private sector nor the flow of investment resources into them had been studied sufficiently to permit effective administration of licensing for the private sector. While this is true, this technical difficulty can in no way justify authorization for capital goods imports which were a multiple of the order of magnitude permitted by the exchange resources available. The pertinent Indian bureaucracy was just not disposed to that degree of curtailment of the private sector.

B: Domestic Savings and Investment

On the problem of domestic savings and their flow into investment, only a few observations will be made here—to illustrate rather than to demonstrate. The Plan anticipated that the economy's savings would on the average double in 1956/61, as compared with 1951/56. The Plan envisages full utilization of these savings, but with a marked diversion from private to a sharply expanded public sector. Yet there is little evidence that the important changes in specific flows of resources implicit in the situation had been traced through and appraised. There is to be a very large expansion in public savings (attributable to the increases in revenues rather than to any reduction in government expenditures for non-development purposes). The most extreme
assumption which seems to be implied is that there will be essentially no expansion in the absolute amount of self-financing by agriculture and small enterprises. Indeed, the very rough estimates that are possible in these two areas suggest that what was an average direct flow of monetized savings to investment in excess of Rs. 200 crores yearly during the first Plan was to remain below Rs. 200 crores in the Second Plan. Nonetheless a significant expansion in income is expected to occur, and the prospect for future incomes is supposed to remain favorable.

Moreover, it is precisely in these sectors of small enterprise—agriculture and other—where the Plan's investment assumptions seem unrealistic, particularly with regard to their private-public balance. Thus, the nature of the Indian development program in agriculture makes these two components complementary rather than competitive or supplementary. Government investment will in general lead to output only when it is accompanied by a necessary amount of private investment. Taking agriculture and irrigation as a whole for the six years from 1950/51 (before the first Plan) this balance was essentially on a 1 to 1 basis. For the Second Plan, public investment in these two sectors was to aggregate about Rs. 800 crores while private was supposed to remain below Rs. 300 crores. This shift in ratio is not even acknowledged in the Plan, which thus provides no basis at all for explaining why public investment at Rs. 800 crores will not need to elicit a higher level of private. In these circumstances, the specific expectation of marshalling private resources for public investment from these sectors seems unrealistic. The tendency will be for resources available to the small scale sector to be invested in the sector rather than in public savings schemes, and the like.
A somewhat parallel argument prevails for the big industry sector. Here, moreover, the situation is complicated by the fact that the Plan speaks of a very large increase in the level of investment in this sector (from about Rs. 325 crores for 1951/56 to Rs. 530 crores for 1956/61). Actually, investment in large scale industry during the first Plan years was about Rs. 500 crores and not the lower figure given in the Plan. The Plan's resource budget (if it may be called this) permits only the maintenance essentially of the investment rates of the previous five years (and, incidentally, of 1950/51 too.)

In such circumstances a short-fall in resources for the public sector appears inevitable, either because the pattern of investment will result in a smaller expansion in income (and hence in taxes and savings) or because greater investment will in fact occur in private activities. This last may be the other side of the overperformance in the private sector observed above.

These problems, it should be noted arise from the domestic savings-investment structure of the Plan itself. At best, the achievement of the Plan's output, savings and investment goals would have required a major effort of analysis and implementation, with the broad use of fiscal and monetary policies on the one hand, direct controls on the other. Given the fact that this would have been a formidable task, government tended more readily to go along with the lesser degree of controls and the lesser emphasis on increased taxation that are in any case preferred.

C: The Capital-Output Ratio

The Second Five Year Plan has been formulated on the assumption that each rupee of additional income will require 2.3 rupees of new investment. For
a number of reasons, including the relatively heavy industrial emphasis of the present Plan, this capital coefficient must be considered as a very low figure. Experience to date has already suggested that the public investment programs, calling for Rs. 3800 crores according to the Plan, may well involve expenditures some 25 per cent higher, due primarily to "higher costs" (which generally refer to more than price increases). Examination of the sectoral experience of the First Plan, to say naught of comparisons with other countries, corroborates such increases. A more realistic calculation is needed, sector by sector, of the capital requirements to produce the expansion in income.

It may be appropriate to observe here that the Plan's target, an average increase of 5 per cent per annum in national income, is a high goal but a goal which may be necessary for a country seeking to shift rapidly from stagnation to progress. One might well argue, given China and given the state of mind in the emerging nations of Asia and Africa, that a lower target would be inappropriate for the nation seeking to make this shift using the political tools of a democratic society.

There is also, of course, the possibility that any increase in investment requirements would need to be financed primarily from abroad. In the Indian Plan the ratio of net imports to total investment is 15 to 20 per cent. Only further analysis of these requirements for Indian investment, and of the mobilizable domestic savings, can provide the basis for a marked increase in this ratio.

D: Immediate Actions

Given on the one hand the overall gap in resources in the Indian Plan ($1.7 billion to $2.5 billion), and on the other the net resources from abroad
which India can more or less count upon to date (1.25 billion), India might now be provided with some assurance that, should she seek aid, there would be an additional billion dollars from the IBRD, from the United States or from other sources, available for this gap, provided need for it is demonstrated. However, there is an immediate foreign exchange shortage, and some allocation of resources (.150 million) might be made at once, thus making possible capital goods imports on government account which should have been imported during 1956/57.

There should be an immediate examination of the drastic curbs put upon private capital goods imports in the past few months. These must inevitably curb entrepreneurial action in a sector which has shown a great capacity for rapid growth, a talent which an economy like India's needs. While the Plan itself and India's socialist approach to its future development suggest that this private action should in fact be curbed, such a course would inevitably affect adversely India's ability to develop particularly in the next 4 or 5 years. It may even be worthwhile for the U.S., or the IBRD, to consider providing further resources, i.e. in excess of the sums suggested, to make possible an expansion in the development effort or to permit other steps, with the objective of preserving for India the energy of this private sector. In any event India's development program needs some basic reassessment, involving a reexamination at least of all the major points discussed above. Given the scale and intent of the new actions proposed, it would seem appropriate to expect an opportunity for a cooperative reappraisal by both financing and borrowing authorities, perhaps through the use of internationally acclaimed experts. Needless to say, downward changes in the Plan should not be considered until such a Plan reappraisal has been completed.