

**THE RATIONALE AND THE RESULT OF THE
CURRENT STABILISATION PROGRAMME**

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I. Introduction:

Apart from the episode of the mid-sixties, macroeconomic crises have not played a major part in India's economic development. A certain sort of stability had accompanied the lack-lustre growth of the economy. Through the Eighties, while many of the economies of the developing world were being forced into the strait-jacket of adjustment programmes, India's policy makers actually availed of the luxury of the most irresponsible kind of macro management. Predictably, this couldn't last long, and soon the economy was engulfed by a payments crisis. Since 1991 the Indian economy has been treated to a true-blue conventional package of stabilisation measures, the contents of which are the focus of this paper. This paper attempts to evaluate the success of the current programme. The task is dogged by two questions. The first is whether two years is long enough a period over which to assess a programme. The second is raised by a sense of the provisional nature of some crucial data, particularly with respect the balance of payments. My response to these important questions is that some sort of a 'progress report' is required and that it is possible to provide one that conveys a reasonably correct picture of the result so far. I attempt to do so here. Also, I deal exclusively with stabilisation. Partly for focus, and in the belief that it is possible, to a large extent, to consider the effects of stabilisation independently. In any case, as far as the Indian situation is concerned it is my appraisal that not a great deal

of structural adjustment has occurred.

This paper is also concerned with a traditional pre-occupation of applied economists. That is, establishing an economy's response when shocked. Stabilisation programmes are historical instances when we get nearest to the 'exogenous change' of economic theory. Theoretical macroeconomics must remain one of the most controversial¹ areas in Economics, and observing the economy's response to shocks is often the only instrument in an applied economist's meagre bag of tools. But I might add that two observations in a turbulent phase can be worth more than a regression using fifty observations spread over a sea of tranquillity. It is in this sense that the current stabilisation programme in India presents a major research opportunity for macroeconomists!

Traditionally, macroeconomic stabilisation programmes in an open economy have been concerned with three objectives.² These are

1. the control of inflation
2. the attainment of a sustainable current account deficit, and
3. the reduction of the level of the external debt.

¹ A recent study by a distinguished player in these debates speaks of seven schools of macroeconomic thought! See Phelps (1990).

² This is not just an academic issue. It is important that one assesses a stabilisation programme on its own terms, or to be precise, in terms of the stated objectives of its votaries. In this connection, it is interesting to note that the objectives as stated above are those recognised by Mohsin Khan, currently the chief economist of the International Monetary Fund. See Khan (1987).

However, more recently, the criterion that stabilisation programmes must be growth oriented has been proposed.³ While it has not been made entirely clear what this entails precisely, it does seem reasonable to expect that stabilisation programmes at least address the question of growth. Thus, it has increasingly come to be understood that a credible stabilisation programme must aim to create the conditions for recovery and thus growth.

Just as I have started with a statement of the objectives of stabilisation policy in general, I would do well to state the conventionally adopted instruments. These happen to be fiscal and monetary policy, and exchange-rate adjustment. Thus, for instance, for an economy undergoing high inflation and a current-account deficit the conventional recipe has been demand contraction via tight money and a restrictive fiscal-stance. Devaluation is added for good measure. These measures do have some sort of underpinning even though it may not be universally accepted. However, of late, we witness the emergence of trade liberalisation as part of the package of measures for a balance-of-payments constrained economy. This is a measure of less theoretical distinction in that its role in stabilising the economy is not unambiguously established.⁴ Finally, I end with

³ See Dornbusch (1990).

⁴ The point is that once the exchange rate is allowed to clear the current account, trade liberalisation can only determine the extent of openness of the economy (crudely measured by the share of imports in GDP), and not the extent of the imbalance between exports and imports (the current account). On the other hand, "...trade reform also complicates the task of macroeconomic stabilisation". See Rodrik (1992) and Mookherjee (1993). While the issue of the extent of openness of an economy is of the utmost importance, what is at stake here is the contribution of trade liberalisation to macro-economic

the observation that many of the instruments cited above are essentially in the nature of targets themselves, for complete control in their use is not a foregone conclusion. They are, then, the 'intermediate targets' of policy jargon.

II. The objectives, the traditional instruments, and some possible pitfalls in macroeconomic stabilisation:

a. Reining-in the external deficit: the twin deficits argument

The idea that the fiscal deficit may be used as an instrument to tackle the current-account deficit has now reached centre stage of the mainstream discussions on macro policy. It is not based on any behavioural model. Nor is it even an empirical regularity. It is based overwhelmingly on the U.S. experience of the eighties when Supply-side Economics, rising defence outlays, and restrictive monetary policy all together contributed to mounting internal and external deficits. The origins of an all-too-true story of the twin deficits are in the standard national-income identity expressing the equality between aggregate supply and aggregate demand in equilibrium. Recall that

$$Y = C + I + G + X - M$$

can be re-arranged, since $Y = C + S + T$, to yield

$$(M-X) = (I-S) + (G-T).$$

Certainly, this expression sustains the interpretation, that the current-account deficit and the government deficit⁵ are linked

stabilisation.

⁵ Henceforth used interchangeably with 'fiscal deficit'.

so long as private-sector behaviour, reflected in the magnitude of the excess or shortfall of private investment over private savings, remains constant. As with all identities, however, causality is a different matter.

Recently, Feldstein⁶ has raised some simple but fundamental questions about the efficacy of cutting the budget deficit in an attempt to reduce the current-account imbalance. Feldstein's contention is that the crucial long-run macro-economic relation is that between saving and investment. Shifts in the budget deficit may be interpreted as shifts in national savings. Now there is no reason why the adjustment must be made via changes in net exports alone. Feldstein's view is that it could equally be made via changes in investment. On the question of the nature of the adjustment, in particular the extent of the improvement in the trade deficit, it is held that this must depend upon:

1. the interest elasticity of investment,
2. the extent to which the exchange rate is affected,
3. the extent to which the trade deficit responds to the exchange rate.

This alternative view of the consequence of budget cuts can be seen from a re-arrangement of the original national-income identity to read:

$$(S-D) = I + NX$$

where (S-D) is national savings, 'S' being the savings of the private sector and 'D' being the public deficit, 'I', as before, is private investment, and 'NX' is net exports. Feldstein also cites the cases of economies as diverse as the U.K. and Mexico,

⁶ See Feldstein (1992).

where success in reducing the budget deficit actually led to current-account deficits.

It has been suggested to me that the proponents of budget-deficit reduction as-a-means-to reducing the external deficit might actually have a more sophisticated mechanism in mind. Specifically, it may be argued that budgetary deficits lead to inflation which contributes to exchange-rate overvaluation and a natural emergence of a current-account deficit. However, if the avoidance of over-valuation of the exchange rate is the issue, it can be taken care of by allowing the exchange rate to float freely. My reason for rejecting this version, however, is based on a belief that the said proponents actually have a more direct relation between the two deficits in mind. This is apparent from the official diagnosis of the current situation in India.⁷

b. Inflation:

Conventionally, demand management is the prescription for inflation control. The fiscal deficit is yet again the principal instrument it seems, though monetary policy is considered to be an active ally to fiscal policy here. Where inflation is an aggregate excess demand phenomenon, this is, of course, appropriate. Moreover, there is no denying the role of demand factors in most inflations. However, the widespread phenomenon of stagflation must raise the distinct possibility of cost-push often being at work as part of the inflationary process. This

⁷ See "Correcting fiscal imbalances" in 'Ministry of Finance' (1993), and also footnote 15.

would immediately suggest the lack of efficacy of pure demand-based strategies, such as demand management. Non-linearities no doubt exist and there might thus come a stage when contraction has gone sufficiently far that even demand-management policies begin to curb inflation.⁸ Even though such a strategy might get to resemble Napoleon marching on, through the icy Russian winter, only to find Moscow burning! I am, of course, referring to the concomitant output loss. Demand management that promises 'disinflation' (the scaling down of prices, quantities unchanged) begs the question.⁹

c. Recovery:

Macroeconomic stabilisation does not have much virtue by itself. It can only be a preamble to growth. The experience of many developing economies that were subjected to conventional macroeconomic strategies during the 1980s is that it is not automatic that these programmes lead to a resumption of growth, leave alone ensuring the transition to a higher growth path. Thus discussion has shifted to the policies that lead an economy from stabilisation to growth. This has also been influenced by a development in economic theory. The short-run focus of macroeconomic policy has for too long been considered to be a legitimate de-limitation. This was so perhaps because macroeconomic theory itself was considered to be concerned

⁸ For the price of raw materials may be expected to be related to activity, and wages must begin to respond to the level of unemployment.

⁹ On the entire set of questions related to the role of demand management in inflation control, and in macroeconomic stabilisation more generally. see Taylor (1990).

with the short run. It was a theory of employment. A separate theory, 'growth', dealt with the long term. It took the recognition of the importance of 'hysteresis' to blur the distinction between the short and the long-run with respect to economic activity. Hysteresis is the property of dynamical systems that the stationary equilibrium is a function of the initial conditions and/or the trajectory to the steady state. Now, traditional macro-policy that focuses on the short-run could actually end up short-termist. A prime example comes from the theory of employment where it has been argued that government policy can actually shift the 'natural rate'. Closer to the concerns of this paper, consider the possibility that dealing with an allegedly 'overheated' economy might actually affect its long-term trajectory, i.e., growth. It has always been recognised that conventional programmes for the stabilisation of an economy can be damaging to growth. This has been the experience of many developing economies in particular. It has by now been identified that this occurs via contraction of investment, particularly private investment. Investment is directly influenced as an outcome of the stabilisation policy and indirectly due to the incentive structure that comes into the picture by the very adoption of a stabilisation programme. Let us take a look at the direct effects first.

1.a Demand management and private investment:

Contraction has been the 'sine qua non' of demand management during a conventional stabilisation programme. This can affect investment. Efforts to reduce absorption inevitably reduces

output. If the accelerator mechanism prevails, and it does, widely, investment must decline. Any initial downturn in output could also affect investment via expectations, of recovery. Investment is put off until the recovery arrives. This is often especially so in projects with a short gestation. And it can only delay the recovery further.

As to why demand management affects output, consider the manner in which the principal instruments work. First, monetary policy is considered to affect aggregate demand via investment, either through interest-rate policy or by credit rationing¹⁰. Secondly, where 'crowding in' rather than 'crowding out' characterises the relation between public and private investment, the fiscal deficit, which would determine the extent of capital spending by government, would have a direct bearing on private investment. Now, when demand management is intended to be deflationary and fiscal and monetary policy is geared towards this objective it can directly reduce private investment and thus output. Serven and Solimano¹¹ cite studies that point to a complementarity between private and public investment in developing economies. Heilbroner¹² points to work on the U.S.

¹⁰The first, of course, assumes that investment is interest elastic. That credit rationing is likely to curtail output in general, and investment in particular, is not controversial. Those interested in the development of macroeconomics would notice the model of monetary policy that underlies this account. From Khan, op.cit., it appears that this is the way that contemporary policy-makers think. It differs from the classic statement of Friedman (1968) which has monetary policy affecting output only via its influence on the labour-supply decision.

¹¹ See Solimano and Serven (1993).

¹² See Heilbroner (1992).

economy that reveals much higher multiplier effects of public over private investment. This has a bearing on the practice of cutting public expenditure to contain the fiscal deficit. The political economy of expenditure cuts in the face of resistance from interest groups often implies that it is the public investment programme that is the first to go. This, of course, is no longer pure Economics.

i.b Exchange-rate policies and private investment:

The argument that the exchange rate policy accompanying conventional stabilisation programmes could be harmful to private investment is based on the assumption that devaluation occurs. If it does, goes the argument, then investment is affected in two ways. First, via the cost of imported capital goods, which rises. Secondly, via the contractionary impact of devaluation on aggregate demand and thus on investment via the mechanisms outlined in section i.a. As for the first, the impact of devaluation is no different from the impact of higher prices of capital goods, and there is no evidence that investment is determined by the price of investment goods 'per se'. As for the second channel, it is more likely than not that the contractionary effects of devaluation can be exaggerated in the Indian case where the trade sector is less than ten percent of the economy, and where too imported consumption goods do not enter the wage basket on a scale that they do even in other developing economies, such as in Latin America. These observations are important because the envisaged route to contraction following from devaluation is via a decline in the real wage.

ii. Private investment and the incentive structure:

Recently, there has been some interesting work on the behaviour of investment during stabilisation programmes. Most contributions play on the old idea of investment being an irreversible decision having to be taken in an uncertain environment. In fact, the importance of uncertainty flows directly from the irreversibility of the investment expenditure, taking on the form of sunk costs.¹³ It is pointed out that the opportunity cost of investment is the "option to wait".

It is argued that the uncertainty involved makes the 'macroeconomic environment' to be as important as tax incentives or the interest rate in determining investment. The literature, however, is somewhat silent on what is meant by 'the macroeconomic environment', even though inflation is cited. A related argument stresses the relationship between 'credibility' of government policy and the incentive structure faced by firms. The argument is made more strongly in the instance of structural reforms, but it does hold for stabilisation programmes too. Quite simply, if the private sector finds the government's stated intentions (either to reform or to stabilise the economy) less than credible it is likely to postpone investment decisions. The irreversible nature of investment decisions makes for the possibility of an irreversible mistake. Finally, an aspect that has a bearing on the incentive structure faced by potential investors is not related to either stabilisation policies or to structural reforms but to a characteristic of most economies that

¹³ See Pindyck (1991).

undertake either. This is debt overhang. The repayment of debt involves transfer to the country's creditors which leads to expectations of large swings in taxes or in aggregate demand in the future. Essentially, the repayment of debt is equivalent to a tax on incomes in the future, and is believed to act as a dampener on private investment.

While the incidence of each of the above mechanisms is hard to establish, the question of the behaviour of investment in general and of private investment in particular has been entirely ignored in assessments of the progress of the current stabilisation programme in India. To the extent that capital formation is vital to growth this is a major oversight. Proponents of the conventional package will argue that stabilisation of the economy will bring about an increase in investment by itself. It is the existence of such an automatic mechanism is that is in question.

III. Macroeconomic stabilisation of the Indian economy, 1991-93:

Perhaps the most concerted attempt ever to stabilise the Indian economy was launched in July 1991 when Mr. Manmohan Singh presented his first Union Budget. It cannot be established that two years is a sufficiently long period over which a major stabilisation programme may be assessed.¹⁴ However, it certainly

¹⁴ A reading of the Finance Minister's speech to parliament on the occasion of the presentation of the Budget for 1993-94 suggests that he holds the view that the economy has actually been stabilised.

is not too early to take a look at how the economy is responding. I shall assume¹⁵ that 'fiscal correction' has been the lodestar of the stabilisation programme. And I shall look at three aspects, its success with respect to inflation and the external position, and the extent to which we can say that the conditions for growth are now in place.

1. Inflation:

In Table 1 are presented figures reflecting the fiscal stance and the behaviour of prices and output in the year preceding the launch of the stabilisation programme and in the two years since. The movement in the fiscal deficit and the inflation rate is not always in the direction predicted by the theory of inflation control by demand management. For instance, in the first year of the stabilisation programme, 1991-92, the inflation rate accelerates, despite a slash in the fiscal deficit. For the subsequent year though, the demand-management story seems to come into its own. We get a little more handle on the explanation, however, if we look at the performance of the agricultural sector. Now note that the fluctuations in the rate of change of the price of foodgrains are entirely correlated with the inflation rate, as they should be, if only for the reason that agricultural prices account for a large weight in the index of general prices. However, these correlations actually signal a

¹⁵ "At a macroeconomic level, fiscal deficits inevitably spill into balance of payments problems and create inflationary pressures in the economy." 'Economic Survey 1990-91', p. 99, New Delhi: Ministry of Finance, Government of India.

complete story of the decline in the inflation rate and the manner in which the programme of fiscal contraction has worked its way through. This is spelt out below.

TABLE 1: The fiscal stance and the behaviour of prices & output

		OUTPUT:		PRICES:	
Year	Fiscal Deficit	Manufac- turing	Foodgrain	Foodgrain	General
1990-91	8.4	9.0	3.2	8.4	10.3
1991-92	6.0	-1.6	-5.3	20.8	13.7
1992-93	5.2	1.6	5.7	12.0	10.0

Notes and Sources: Fiscal Deficit (as percent of GDP) is from the 'Economic Survey 1992-93'; Output figures are annual rates of growth; Foodgrains output for '92-93 is that anticipated- 'Economic Survey'; Manufacturing output for 1992-93 alone is the rate of growth for the first eleven months over the same period of the previous year (calculated from data in "Annual indicators", 'CMIE', May 1993), figures for other years from 'Economic Survey'; Prices refer to the annual changes in the wholesale price index - calculated from 'RBI Bulletin', September 1992 and "Annual Indicators", 'CMIE', May 1993.

The inflation rate follows closely upon the behaviour of agricultural prices, which follows the performance of

agricultural production. This is so because despite the very considerable likely influence of government operations, both in the nature of price support and of quantitative intervention, it is supply shocks that drive¹⁶ the change in the price of foodgrains in the Indian economy. The deflationary stance may have contributed indirectly, if at all, by slowing down activity in the non-agricultural sector of the economy. Slower growth of the latter could affect inflation directly by lowering demand for agricultural goods. But even this indirect role of stabilisation policy may have been very small indeed, for the growth of manufacturing appears more closely related to agricultural (foodgrains) growth than it is to the fiscal deficit. This is indicated by the turnaround in manufacturing growth in 1992-93 despite the continuing 'fiscal correction'. Agricultural performance reverses itself considerably in this year.¹⁷

I end with two observations. The only challenge to the story that inflation is determined by fluctuations in agricultural production comes from the widely noted result from estimation of foodgrains-price equations for India that it is lagged rather than current output¹⁸ that affects price. If this is entirely so, the explanation of fluctuations in the inflation rate that I provide above cannot hold. It is my view that as with all econometric evidence this one too requires scrutiny. To an

¹⁶See the econometric estimates of foodgrain price (change) equations in Balakrishnan (1991).

¹⁷The picture emerges clearly from Table 1.

¹⁸See Balakrishnan, op.cit., and Pandit (1978). Pandit uses the simple average of current and lagged annual production.

extent, the result could be due purely to accounting practices, in that some part of an (agricultural) year's output reaches the market only in the next financial year. The very highly aggregative (all crop) models and low frequency (annual) data used are a part of the explanation too. Upon reflection it is unlikely that any year's agricultural output can have no effect on prices in the same year. Certainly, there is one piece of evidence that suggests that the positive agricultural supply-shock of 1992-93 might have something to do with the reduction in the inflation rate in that year. This is that seasonality implies that in every year the rate of change of prices is lowest in September, when the first harvest in the year takes place, and the kharif marketing-season commences. In September 1992, the price of foodgrains actually fell, giving a negative inflation rate. It continued to fall, or remained stationary, for seven successive months.¹⁹ The kharif harvest of 1992 was higher than that of the previous year by 7.2 percent.²⁰ 'Supply-side serendipity' seems to me about the right way to characterise the role of the policy maker in the reduction of the inflation rate.²¹ In fact, that a sustained reduction of the fiscal

¹⁹ Since information on this is so easily had, I do not present it in the text.

²⁰ 'Annual Indicators', May 1993, Bombay: CMIE.

²¹ What about a possible role for a stabilising government via its influence on expectations? This is much emphasised by those adhering to the tenets of the 'rational expectations' approach. It is not implausible, but it needs to be established in term of an explicit model of expectations formation. Resorted to very often in explanations of economic phenomena, the reference to 'shifts in expectations' can be no more than a fudge. At another level my judgement is influenced by the belief that the role of expectations in the inflationary process in the

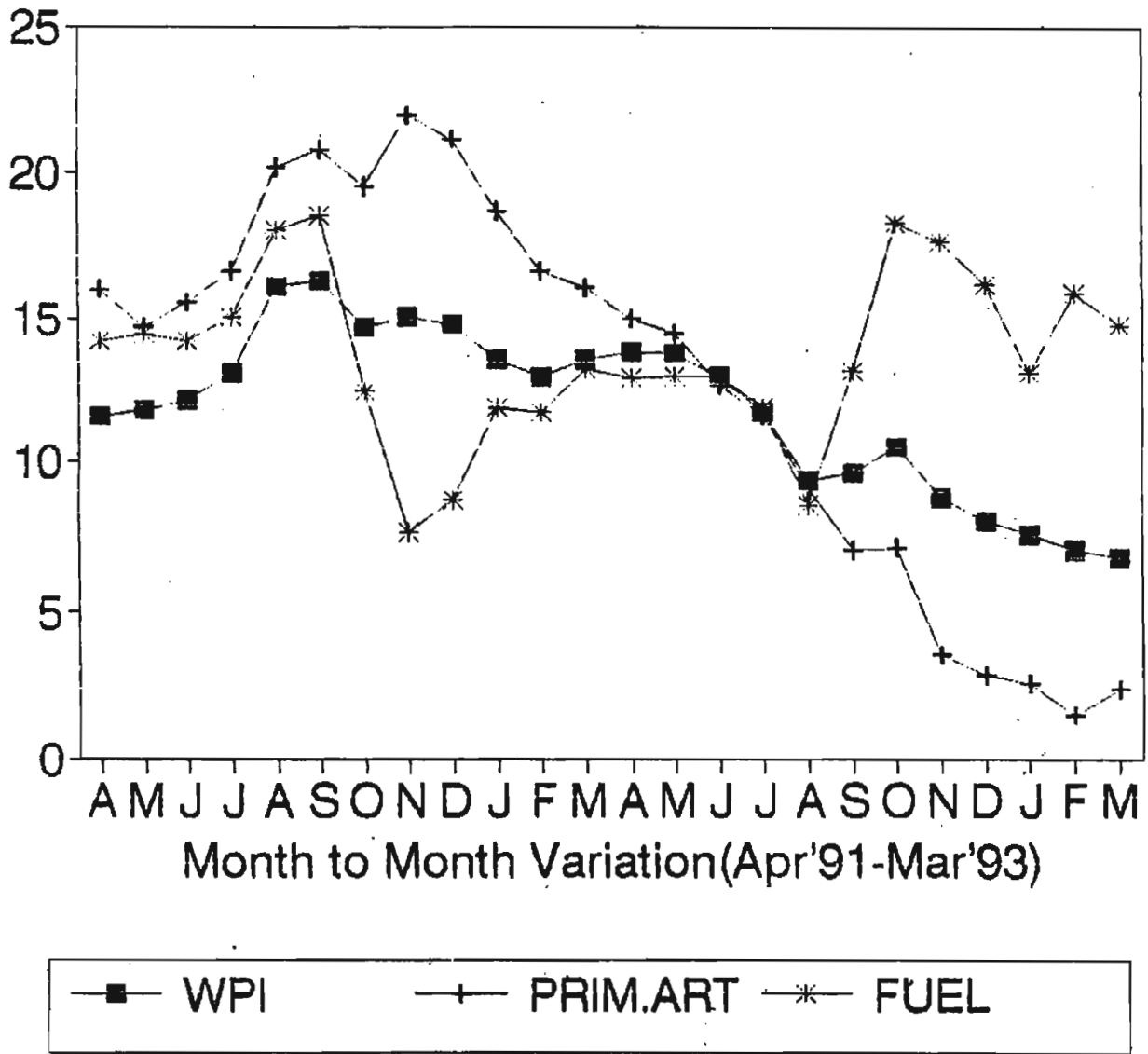
deficit could bring about a less than twenty-five percent reduction in the inflation rate despite a quite considerable windfall (in the form of improved agricultural performance) on the supply-side while industrial activity was slack for the second year running²² speaks poorly for the efficacy of demand management in inflation control. Obviously engineering a recession can help only thus far. The role of procurement-price hikes is all too apparent.²³ Finally, note that the explanation of the course of inflation over the two years provided here diverges from that given by both the votaries and the critics of the Finance Minister. The former admit of no chink in the armour of 'fiscal correction', evidenced by the lack of a correlation between the fiscal deficit and the inflation rate in the first year of the stabilisation programme, taking recourse to the argument that the inflation rate in 1991-92 would only be expected to be higher since some key administered prices were raised (or rose upon de-control) as part of the reform process. Basing themselves upon a similar view of the determinants of inflation in the year 1991-92 the critics argue that the subsequent decline in inflation is essentially an 'artifact' reflecting only the artificial high engineered in that year. The

Indian economy is not a major one (at least thus far). Interestingly, this appears to be a view shared by a leading contemporary policy-maker! See the interview with Mr. S. Acharya, Chief Economic Adviser to the government of India, in 'Economic Times', Bombay, 20 July 1993.

²² See Table 3.

²³ A discussion of the likely role of procurement prices in the inflationary process in India appears in Balakrishnan, op.cit. For a clear statement the limited possibilities for macro policy in the face of price 'shocks' see Gramlich (1979).

Figure 1
Inflation and Sectoral Prices.



point is that the rise in the relative price of agricultural goods (foodgrains), evident from the figures in Table 1, puts paid to the argument that the principal cause of the higher inflation rate in 1991-92 is due to the hike in administered prices.

The figures on inflation presented in Table 1 are annual averages.²⁴ In an effort to get closer to the path of inflation, and what I consider are its principal determinants, I look at the monthly rates of change on inflation and some crucial price aggregates. These are plotted in Figure 1, and demonstrate the applicability of the explanation of inflation that I have provided. Notice that it is incontrovertible that it is the slowing down of the growth of agricultural prices that has brought the inflation rate down over the 21 months since July 1991. Naturally the decline in the price of 'primary articles' is greater than that of the inflation rate. This must be so. First, 'primary articles' account for only about a third of the 'general' (all commodities) price index used to measure inflation. Secondly, the index of the price of 'fuels' has fluctuated some.

2. The external sector:

Even before taking a look at some of the performance indicators for the external sector of the economy it pays to recall that it was the very precariousness of India's external payments position in mid-1991 that was evoked to rationalise the stabilisation

²⁴ See notes to Table 1.

programme that followed. Naturally, therefore, it would be with respect to the external sector that one would most seek results.

TABLE 2: Transactions on external account

	1990-91	1991-92	1992-93
Trade balance (\$ million)	-5930	-1545	-3305
Export growth	9.1	-1.5	3.1
Import growth	13.2	-19.4	11.9
Current a/c (\$ million)	-7727	-3169	-5244 *
:as % of GDP	2.6	1.3	2.2 *
External debt (Rs. crores)	122950	198967	202972
Debt-service\ Exports ratio	28.3	30.6	---

Notes: * estimated; --- not yet available; the external debt figures for 1992-93 is that outstanding in September 1992, in other years it is that outstanding at the end of every March.

Sources: 'External debt' from 'Economic Survey 1992-93', MoF; 'Debt-service ratio' from 'World Debt Tables', The World Bank; rest from 'Ministry of Finance', (1993).

Two observations come to mind from a viewing of the data related to transactions on external account over the period 1991-92 to 1992-93 that are presented in Table 2. First, there has been no very great improvement in the payments position over the period as a whole. Measured as a percentage of the GDP, the (estimated) current-account deficit is only a little lower at the end of 1992-93 than it was in 1990-91, the year preceding the stabilisation. It is not as if there is much of a difference in the manner in which the trade deficit has moved either. Read in conjunction with the information in Table 1 we are able to gather that the continuing fiscal contraction has not been able to make much of a difference to the external deficit. Neither has the nominal devaluation of June 1991. The considerable improvement in both the trade balance and the current-account balance during the year 1991-92 should actually be seen in perspective. This improvement was brought about by the severe import compression put into effect by the Reserve Bank of India independently of the stabilisation programme, and even prior to its launching. The results of the import compression may be seen in the decline in the rate of growth of imports in 1991-92, and the consequent contraction in industrial production in the same year. The import compression was lifted only after the reserves position improved towards the end of 1991-92, partly due to borrowing from the international financial agencies. Imports soared in 1992-93 despite the continuing reduction of the fiscal deficit, pointing to the relative efficacy of import compression versus aggregate-demand contraction in the short-run. In this year, the trade deficit doubled and industrial production improved. The exact

role of import compression in having improved the trade account in 1991-92 is difficult to establish. This is so because the period of the stabilisation programme has witnessed considerable fluctuation in agricultural production (Table 1), and we know that agricultural fluctuations influence industrial growth rates directly. In an economy where imports are in the nature of capital goods and intermediates, they are bound to be affected directly by the rate of growth of domestic industrial production. However, it is the very great fluctuation in the growth of imports (Table 2) over the past two years that would lead one to believe that import compression has had an independent influence. That the policy approach to the current-account imbalance is less than in control is indicated by the trends in the components of merchandise trade over the period we are looking at. Note that while there is at least a slight reduction in the growth of imports by 1992-93, export growth continues to be well below what it was before the programme had started.²⁵

My intention here, as throughout this study, is two fold. One is to try and understand the working of macroeconomic policy and the other is to evaluate the progress of the current stabilisation programme. Starting with the question of the success of policy on the external front, the review can hardly be favourable. It can, of course, be argued that macroeconomic stabilisation is less concerned with magnitudes than it is with

²⁵ The quite remarkable performance of exports in the first two months of 1993-94 must be noted. In fact, with the decline in the growth of imports the trade balance in these months is almost positive. See the reportage of the provisional estimates of the trade figures by the Commerce Ministry in the 'Economic Times', Bombay, 14 July 1993. The interesting question is whether this represents a turnaround in the economy's b.o.p. position.

the 'sustainability' of a certain payments position. This is an argument that can be heard quite often. However, apart from the lack of economic content to this concept, in my view, this is a somewhat 'short termist' approach. In the sense that, technically, sustainability can be ensured via capital inflows. Ultimately, re-payments or outflows must be met in hard currency. This can come about only via secular improvements in the trade balance. In the absence of a 'portmanteau' indicator of the state of the external sector of the Indian economy I shall point to two, namely, the level of external debt outstanding and the debt-service to exports ratio. The first is a clearly defined target of stabilisation policy and the second captures, in a summary way, the economy's capacity to repay and/or the burden of (its) debt. Notice, from Table 2, that the level of international debt outstanding is actually growing, though at a slower rate. Not surprisingly, the lack-lustre export performance has meant that the debt-service (to exports) ratio too has grown²⁶ since the beginning of the stabilisation programme, indicating that the economy's capacity to repay is weakening. It is this continued dependence on external borrowing in the absence of a well-defined strategy for repayment that constitutes the principal weakness of the current programme.

Two years into the macroeconomic stabilisation programme India's external payments position continues to remain vulnerable. My own view is that the package of measures

²⁶To the extent that India is now to be termed a 'severely indebted' economy by the World Bank's classification. See any recent issue of the 'World Debt Tables'. The figures for the year 1992-93 are not yet available.

associated with a conventional stabilisation programme is hopelessly ill-equipped to deal with the current balance-of-payments situation in India. An economy starting out with a sizeable foreign debt, and contracting more to stick to its repayment schedule, can expect to be able to free itself of debt only if it significantly steps up the rate of growth of its exports. It is quite obvious that fiscal correction by itself cannot achieve this. Demand contraction should lower imports for any economy with a standard import-demand function. Exports however would require a separate instrument. Recently, Panagariya has given us an account of the trade regime underlying China's miraculous export performance in the eighties. It is instructive to note his views: "...a key objective of China's trade policy reform has been export expansion. Several specific policies have been adopted to achieve this objective. These include geographical targeting, sectoral targeting, direct export rights, foreign exchange retention rights, and export quotas. Policy initiatives at the local level also influence exports."²⁷ The upshot of all this is that a faster rate of growth of exports requires the policy maker to get the right incentive-structure into place. Of course, the challenge, as always, is to ensure that intervention is not dissipated by rent-seeking activity.

Since this paper is concerned with policy we might question the excessive importance given to the 'macroeconomic environment' in conventional stabilisation-policy packages and, increasingly, in contemporary assessments of the health of the Indian economy. The relationship between the 'fundamentals' and export growth is

²⁷ See Panagariya (1993).

not at all obvious. Perhaps even it is exaggerated. It is certainly one of the readings of the career of the stabilisation programme in India.²⁶ Successful export growth is likely to require a whole gamut of interventions under the name of 'export promotion'. This only stands to reason. Recall the well-known rule of economic policy, due to Tinbergen, that you need as many instruments as there are targets. We now see the inadequacy of the strategy termed 'fiscal correction'. It can lower imports, via contraction of the economy, but it has nothing in it to deal with exports. On the whole it is a blunt instrument given the task.

3. The conditions for recovery:

It is indeed difficult to establish whether a particular programme of stabilisation has succeeded with respect to the creation of the conditions for recovery. At least partly because we can never be fully certain of what these conditions are precisely. A rough-and-ready procedure might be to track the behaviour of investment and the other is to look for evidence of growth.

The considerable lag in the availability of data on investment implies that we cannot really pursue the former. However, I wish to point out that the 24.1 percent decline²⁹ in

²⁸ It might be instructive to look at views on the experience of South Korea. Collins has argued, in response to Dervis and Petri, that even if it is the case that macro-management has been sound in Korea, it is aggressive micro-level interventions that made the difference.

²⁹ From quick estimates of national income for 1991-92 by the CSO, re-produced by the Centre for Monitoring the Indian Economy, Bombay, January 1993.

investment in the manufacturing sector of the economy for the year 1991-92, the first year of the programme, conforms to the pattern associated with conventional stabilisation programmes.

TABLE 3: Activity

Quar. \ Year	1990-91	1991-91	1992-93
1st Quarter	195.2	188.2	195.8
2nd Quarter	196.5	194.4	199.5
3rd Quarter	203.4	196.3	205.2
4th Quarter	237.1	238.5	(211, 210.5)

Notes: The index of output in manufacturing base 1980-81=100. Figures entered for the 4th quarter of 1992-93 are those registered in January and February, respectively. The figure for March is yet to be announced. Source: Figures for 1992-93 from 'Annual Indicators', 'CMIE', Bombay. The rest from 'RBI Bulletin', October 1992.

We are better placed to consider the question of recovery. In Table 3 are presented quarterly index numbers of industrial production (manufacturing). Manufacturing is selected in the belief that it is in manufacturing that production is most responsive to the policy environment. Now note that, quarter-wise, performance during 1992-93 does not vector-dominate

performance during 1990-91. This arises from the poor performance in the last quarter of 1992-93. Of course, even if the last quarter is ignored 1992-93 does not turn in a very greatly improved performance over 1990-91. Growth is yet to resume, let alone with vigour.

IV. Conclusion:

To the extent that the current stabilisation programme has placed centre-stage the reduction of the fiscal deficit it has progressed steadily. However, it's achievements to date are not impressive.³⁰ The inflation rate has been lowered, but its trajectory has been guided almost entirely by agricultural production. The latter takes the form of an exogenous event for which the package of measures that make up the stabilisation programme can take little credit. It must be acknowledged though that there has not been an acceleration of the inflation rate as was witnessed in the case of Latin American economies undergoing stabilisation programmes and structural reform. Thus generalised opposition, in mid-1991, to any kind of reform of the Indian economic system on the grounds that it will lead to accelerating inflation seems misplaced. As regards the external sector, the stabilisation programme has very little to show indeed. Not only is the level of external debt outstanding actually higher, the slow growth of exports has meant that the economy's capacity to repay is not growing. In fact, the debt-service ratio registered at the last count suggests that this capacity might actually have

³⁰ For a sceptical appraisal of the prospects at the outset of the programme see Rakshit (1991).

declined. This is not encouraging. Finally, while there is no definite method of establishing whether the conditions for recovery have been created, judging from the performance of the manufacturing sector it seems likely that growth will be slow in coming. I would hope to have pointed out that the stabilisation programme in India is one target too short. Essentially there is no concern with the level of activity.³¹

I would also have hoped to demonstrate a more general point; that the macro-economic environment, and thus macroeconomic policy, has a limited role. Policy regimes are enabling, rather than causative. This is an important point to bear in mind. Protagonists of the 'markets versus controls' debate tend to overlook this, often rendering it sterile. At the present stage of the Indian economy, the questions of the engine of growth and of the means to be adopted in transforming its status from that of a poor trader on international markets remain to be addressed. That I have questioned the rationale of the stabilisation programme currently on and balked at claims of an unalloyed success thus far do not in any way detract from the powerful arguments for reform in India or for the importance of trade for India's economic development. These are separate issues.

³¹Those interested in the history of the theory of economic policy will recall that in the classic analysis of options for a balance-of-payments constrained economy by Meade (1951) the prescription for curing the trade deficit was a reduction of 'absorption' or aggregate demand. However, simultaneous devaluation of the currency was recommended to switch demand towards domestic production so that domestic activity levels are maintained. Of course, we now know that under certain conditions devaluation might be contractionary. The point though is to note the concern for output loss. No such recognition informs the current programme in India.

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