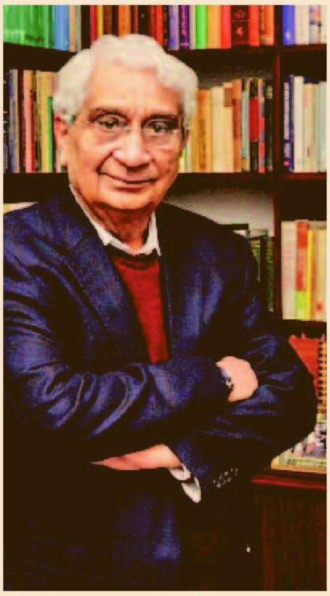
Business Standard Epaper

'Incomplete 1991 reforms failed to foster India's industrialisation'

35 years of liberalisation

Q&A The 1991 reforms resulted from crisis management efforts spanning multiple governments, says **Deepak Nayyar**, who was the chief economic advisor to the government in the finance ministry during the governments led by V P Singh, Chandra Shekhar and P V Narasimha Rao. However, once the essential fiscal adjustments were made by the Rao government, the structural reforms lacked crucial policies needed to supplement them, leading to India's long-term de-industrialisation, he tells **Gireesh Chandra Prasad** & **Asit Ranjan Mishra** in an interview. Nayyar, who moved out of the finance ministry in late 1991 to pursue an academic career amid differences with then finance minister Manmohan Singh, speaks about the vulnerabilities in India's reform journey and what needs to be done to realise its demographic dividend and avoid the middle-income trap. Edited excerpts:



What led to the crisis of 1991?

■ I believe the problem began during Indira Gandhi's second term, but it worsened significantly in the five years that Rajiv Gandhi served as Prime Minister. The fundamental problem was excessive borrowing at home and abroad. It led to mounting fiscal deficits for the government and burgeoning current account deficits for the economy. The fiscal profligacies of the 1980s were undeniably responsible for the macroeconomic crisis in 1991.

Can you provide a sense of the firefighting the government did in 1991?

■ I was Chief Economic Adviser and Secretary in the Ministry of Finance for two years. I was the only secretary (apart from K P Geethakrishnan, the then expenditure secretary) who served under three Prime Ministers —Singh, Chandra Shekhar and Rao — and three finance ministers — Madhu Dandavate, Yashwant Sinha, and Manmohan Singh — during the most acute economic crisis in independent India.

The competitive politics of populism and the cynical politics of soft options during the 1980s led to an unsustainable fiscal regime. Neither the economy nor the government could live beyond its means forever.

The minor oil shock of 1990, when Iraq invaded Kuwait, proved to be the proverbial last straw on the camel's back. The prospect of default hung over our heads.

The political uncertainties compounded difficulties. It was firefighting day by day and surviving month by month. The short-term debt was $6 billion rolled-over every 24 hours, outstanding NRI (non-resident Indian) deposits of more than $10 billion were prone to capital flight, while foreign exchange reserves were a mere $1 billion — not enough to finance imports even for a fortnight. In mid-October 1990, the V P Singh government decided to approach the IMF for a loan.

I led the negotiations with the IMF and the World Bank throughout this period for one year, assisted by C Rangarajan, then Deputy Governor of the Reserve Bank of India (RBI), Gopi Arora and Jagdish Baijal, our Executive Directors in the IMF and World Bank, respectively, and N K Singh, who was then Joint Secretary. It was a continuum, which began in November 1990. The following four months witnessed the fall of two governments, followed by a prolonged interregnum until the elections in May-June 1991.

In January 1991, I led our negotiations with the IMF for borrowing under the first credit tranche and the Compensatory and Contingency Financing Facility (CCFF) to obtain $1.8 billion with minimal conditions.

'Demographic dividend accrues only if we create capabilities via education' 7

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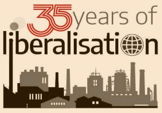
Demographic dividend accrues only if we create capabilities via education: Deepak Nayyar



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It was the determination of the government to avoid default and the stature of India even in difficult times that helped us drive a hard bargain.

The Union Budget to be presented in February 1991 was ready but the Congress withdrew support just a few days before. Only an interim Budget was presented. Yashwant Sinha is correct that had the Budget been presented — which was not significantly different from what was presented in July 1991 — he would have got the credit for the fiscal adjustment and structural reforms.

The liquidity crunch resurfaced. There was capital flight from NRI deposits. Cash margins on imports were raised to a whopping 200 per cent. Gold worth $200 million, confiscated from smugglers, was sold in April 1991, approved by caretaker PM Chandra Shekhar.

It had all the attributes of a thriller. Rangarajan travelled with a cavalcade of armoured vehicles. We managed to keep it out of the newspapers despite intense scrutiny.

At one point, to prevent speculation, the Cabinet Secretary, the Finance Secretary, and I invited newspaper editors for dinner. We explained the deep crisis and sought their cooperation, highlighting how screaming headlines might undermine international confidence. I must add that the situation eased thereafter.

Many people think of the Union Budget and economic reforms as a magical event in July 1991, but it was part of a continuum.

The blueprint for fiscal adjustment was already in place earlier in 1991, based on discussions between Cabinet Secretary Naresh Chandra, Finance Secretary S P Shukla, RBI Governor S Venkitaramanan and me as CEA, as well as consultations with Industry Secretary Suresh Mathur, Commerce Secretary Montek Singh Ahluwalia, and Petroleum Secretary Ashok Chandra, on structural reforms.

How did the initial days of the Rao government go?

■ On June 20, 1991, the evening before Rao was sworn in as Prime Minister, Naresh Chandra called me and S P Shukla to brief the PM designate.

I prepared a three-page note on the crisis and added a half-page handwritten annex outlining necessary actions. This included an exchange rate adjustment, pledging 15% of the RBI's gold reserve assets with the Bank of England, a major adjustment to reduce the fiscal deficit to 6.5 per cent of GDP by slashing food and fertiliser subsidies, while raising petroleum prices, as well as some contours of structural reforms in industrial and trade policies.

These proposed actions were explained to Rao before he was sworn in as PM. I also suggested he make a television statement expressing confidence despite inheriting a difficult situation. He did so the next day based on the text we provided.

In the following month, we implemented several critical measures including the exchange rate adjustment, abolition of all export subsidies and shipment of 15% of RBI's gold as reserve assets.

All this was done in the first two weeks of July 1991. On July 24, 1991, the new industrial policy was announced in the morning. Rao also held the industry portfolio. Then, Manmohan Singh presented the Union Budget in the evening.

Any government that came to power in mid-1991 would have done the same. The blueprints existed. There was little choice.

Obviously, such significant decisions could not have been formulated or implemented in just one month without prior planning. Rao was incredible in his prime ministerial role, demonstrating his ability to make decisions combined with deft management of a minority government that had not yet established its majority in Parliament.

Rao's low-key political management surprised me. It was his decision-making that made the adjustment and reforms a reality. The irony is that, in retrospect, it is Manmohan Singh rather than Rao who gets the credit for the 1991 reforms. This is how myth becomes legend. Legend might not become history, if the archives and records from that period are made available to scholars for research.

What were your differences with Manmohan Singh on reforms?

■ I left the government at the end of December 1991 and returned to academia. My differences with him were not on fiscal adjustment. It was sorely needed. In fact, I wanted to go further on that. My differences and concerns were primarily on structural reform.

> "INDUSTRIALISATION IS NOT ABOUT PASSIVE INSERTION INTO THE WORLD ECONOMY. IT IS ABOUT STRATEGIC INTEGRATION... OUR TRADE LIBERALISATION DID NOT FOSTER INDUSTRIALISATION BECAUSE IT WAS NOT COMBINED WITH AN EFFECTIVE INDUSTRIAL POLICY"
>
> Deepak Nayyar, Former CEA

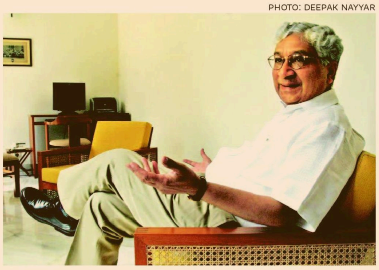
PHOTO: DEEPAK NAYYAR

Industrial policy reform that removed entry barriers for new firms and limits on the size of existing firms was both necessary and desirable, but the competition law came more than a decade later. Trade policy reform was much needed but its pace hurt the industrial sector, exacerbated by the absence of effective anti-dumping laws without doing anything to create an ecosystem that would support manufacturing. Public sector reform was no more than asset sales, which meant selling the flagships and keeping the tramp ships. Financial sector reforms dispensed with over-regulation, but did not create structures of regulation and governance.

In sum, I had concerns about the nature and sequence of change. While structural reforms were introduced, the institutions and rules necessary to govern the market were not put in place. And 35 years later, my concerns are borne out by the outcomes. India has de-industrialised as the share of manufacturing in output and employment has dropped. The public sector has languished. Scams have continued to surface in the financial sector.

Was Manmohan Singh against your ideas?

■ I cannot speak for him now that he is no longer alive, but there were differences of opinion, which is only natural among economists and policymakers. I articulated those differences. Rao would sometimes look at me and ask whether I agreed. In sum, there was agreement on the contours of fiscal adjustment, but differences on the nature of structural reforms.

So, broadly, reforms should have been complemented by a strategic industrial policy?

■ Yes, absolutely. The absence of industrial policy is also an industrial policy. It has led to de-industrialisation. No country in history has industrialised without an industrial policy, including the United Kingdom and the United States, and the now successful Asian economies like South Korea, Taiwan, China, and Vietnam.

Industrialisation is not about passive insertion into the world economy. It is about strategic integration. India's share in world manufacturing value-added in 1970 was 1.1 per cent, while China's was 0.8 per cent; by 1990, it was the same at 1.3 per cent. In 2025, India's share was 3 per cent, while China's was 28 per cent. Our trade liberalisation did not foster industrialisation because it was not combined with an effective industrial policy.

We were the pioneers in development banks, which China and Brazil later emulated, but we closed them down. Stock market capitalism creates barriers to entry in financial markets for new entrepreneurs. In some countries such as Brazil and China, indeed even Germany and Japan, nearly half of the private investment in manufacturing is financed by development banks.

Why did we end up like this?

■ Essentially because we did not create an ecosystem conducive to manufacturing. In my view, India should have increased the openness of our economy in the early 1970s, as East Asian countries did. We were 20 years late and did it without a sensible industrial policy. States and markets are complements, not substitutes. The relationship between the state and the market must change as times and circumstances change. Efficient markets and effective states, together, make for success in development. This proposition is validated by the Asian success stories. Our research and development (R&D) expenditure as a share of GDP has declined from 1990 to now, while China's has risen.

What was Manmohan Singh's exact contribution to the structural reforms?

■ It is quite difficult to pinpoint significant actions that were not part of the extensive reform programme already conceived. And it was Rao who made the difficult, critical decisions. I resigned from the Ministry of Finance and left on December 31, 1991. Thus, I can only speak about the period from June to December 1991, when I was present in almost every critical meeting making decisions, including Cabinet Committee on Economic Affairs and Cabinet Committee on Political Affairs. For those decisions, Rao deserves the credit. It is neither correct nor possible for me to assess Manmohan Singh's contributions thereafter. The reform process did not end but slowed down after the dramatic changes announced in mid-1991.

What can India do now?

■ There is a need for a strategic industrial policy, which requires a coordination of exchange rate policy, monetary policy, technology policy, industrial finance, and R&D. India should endeavour to improve its quality of education, which is currently deteriorating. In 1990, India's R&D expenditure as a share of GDP was 0.66 per cent, compared with 0.60 per cent in China. By 2024, India's was lower at 0.60 per cent, while China's was far higher at 2.4 per cent. Viksit Bharat (developed India) is not feasible if the education system is declining, with poor learning outcomes and excessive centralisation of admissions processes.

Have we made the most of our demographic dividend?

■ We have wasted an enormous opportunity. The demographic dividend accrues only if we create capabilities in our people through education. If learning outcomes in schools are poor, universities are politicised, and textbooks distort history, I fear for the future. We may end up like the Philippines, or like Latin America, caught in the middle-income-trap.

Employment is our biggest social, economic and political challenge. Manufacturing is our potential source of employment. The informal services sector and construction are the main sources of jobs in India, where wages are low and the quality of employment is poor. The gig economy is similar.