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India's International Financial Difficulties 16 pages

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India's International Financial Difficulties

Yves Maroni

Most of the countries of Asia including India are engaged in heroic efforts to break the vicious circle of economic and social forces which have resulted in a chronically low level of per capita income. Low per capita income is responsible for these countries' low level of savings. These savings finance a relatively low amount of investment which, given the rate of growth of population, tends to accomplish little more than the maintenance of the per capita income level. The problem is to raise per capita income and to promote its continued rise at a rate comparable to that achieved in more fortunate countries.

To solve this problem, many of these countries have embarked upon large and growing investment programs under the overall direction of the State and with a great deal of direct participation by the State. Unfortunately, in many cases, the effort undertaken has been greater than could be financed from available resources, domestic and foreign, and inflation has set in. Miscalculations, erroneous assumptions about the costs of the programs, or about the availability of domestic or foreign resources, have usually been to blame, but resort to inflation has also been to some extent deliberate, in the belief that a faster rate of development would result. In all cases, inflation has led to international financial difficulties.

The international financial difficulties which India is facing today can largely be explained in these terms. They illustrate vividly the enormity of the problem of economic development when the rate of growth of population is high and the income base is small. They deserve careful consideration, not only for the lessons which may emerge and which those interested in problems of economic development may find useful, but also because a study of these difficulties may help American businessmen engaged in day to day dealings with India, government officials concerned with the formulation of U. S. policy toward India, and the public at large anxious to gain increased understanding of India.

The record, 1951-56

In India, population is growing at an estimated rate of about 1.5 per cent a year. The 1951 population was nearly 357 million and the 390 million level should be reached before the end of 1958. For the year ended March 1956, national income in 1948-49 prices was estimated at 104.2 billion rupees (about $21.9 billion), giving a per capita income of 272 rupees (about $57). In that year, consumption of foodgrains amounted to only about 400 pounds per capita. Domestic savings were only about 6 per cent of national income, and the rate of investment, including investments financed by foreign resources, was only slightly higher. Unemployment and underemployment remained tragically high.

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Although the living standards of the Indian people were quite low in 1955-56, an encouraging improvement had occurred over the preceding five years. The estimate of national income in constant prices just given was 17.7 per cent higher than in 1950-51 and the per capita income was 10.5 per cent higher. The index of agricultural production was about 19 per cent higher and that of industrial production about 40 per cent higher. Low though the rates of saving and investment may have been in 1955-56, they too were higher than in 1950-51.

The momentum of the economy which these figures reveal was partly attributable to the weather, as the droughts of 1950-52 were followed by good monsoons in 1953-55. However, it was also the result of the first five year plan, which extended from April 1951 to March 1956. Under the plan, a deliberate effort was made to increase production and to develop the basic facilities (mainly power) needed for further growth. The central and state governments spent about 15 billion rupees on public investment projects and an additional 4.6 billion rupees not labeled investment on other activities included in the plan. Private investment in this period totalled 16 billion rupees, making total plan outlay 35.6 billion rupees (about $7.5 billion).

The progress of this period was achieved under conditions of financial stability. Wholesale prices fell in the last half of 1951 and early in 1952 following the inflationary upsurge of the Korean war boom. Thereafter they fluctuated narrowly, except for a steady decline in 1954 and the first half of 1955 and an ensuing recovery. At the end of the plan period, in March 1956, wholesale prices were no higher than in 1949, a record matched by few other countries in the world.[1]

Price stability was not purchased at the price of external imbalance. The balance of payments remained in approximate equilibrium during the last four years of the plan following a large deficit in 1951 associated with the Korean inflation and its aftermath. At the same time, import and exchange restrictions, which had been tightened as part of the post Korean readjustment, were gradually relaxed.

This record was made possible by the fiscal and monetary policies followed by the authorities. The budget deficits, largely occasioned by growing developmental expenditures, were mostly financed in non-inflationary ways. Inflationary financing, such as drawing down of cash balances and direct sale of Treasury bills to the central bank, remained moderate, at least in the first four years of the plan. Over the five year period, it amounted to about 4 billion rupees (about 20 per cent of the total public outlay under the plan), of which about 1.7 billion rupees was incurred in the last year of the plan alone. The central bank, after withdrawing its

1/ In the United States, wholesale prices were about 15 per cent higher in 1956 than in 1949.

support of the government securities market and raising the discount rate in November 1951, undertook open market sales of securities on a significant scale, particularly in 1953 and 1954. Under these policies, private bank credit as well as time and savings deposits of banks rose moderately after 1953, following the post Korean readjustment. In March 1956, money supply was only about 10 per cent higher than five years earlier.

The second five year plan

The remarkable performance of the Indian economy during the first five year plan led the Indian authorities to adopt a much more ambitious investment program for the ensuing five year period (April 1956-March 1961). They decided that a total of 62 billion rupees should be invested under the second five year plan, twice the amount invested under the first five year plan. An additional 10 billion, not labeled investment, was also to be spent on activities included in the plan, making total outlay under the plan 72 billion rupees, again about twice the total outlay incurred under the first plan. Of the proposed total outlay, the central and state governments together undertook to spend 48 billion rupees, about two and a half times the amount spent by them in the first plan. Private enterprise was to spend the remainder, 60 per cent more than it spent under the first plan.

The inventory of projects included in this plan differed from that of the first plan in that emphasis shifted sharply from agriculture to heavy industry. The relative share of the proposed total public outlay allocated to the development of industry and mining was nearly four times that of the first five year plan while the relative shares of all other sectors was lower, except for a small increase in the relative share going to transportation and communications. For all sectors, however, the absolute amount to be spent was well in excess of the amount spent during the first plan.

Only about half of the public outlay was to be financed from taxation and by borrowing from the public. Another quarter was to be borrowed from the Reserve Bank of India. Another 8 billion rupees ($1,680 million) represented foreign exchange requirements and the balance was to be raised from the profits of state owned enterprises. Resources available to finance the private investment outlay were only partially indicated and included a substantial dependence on bank credit expansion. Foreign exchange requirements of the private sector were estimated at 3 billion rupees (about $630 million). To meet the foreign exchange requirements, it was planned to draw down foreign exchange holdings by 2 billion rupees ($420 million) and to obtain the balance of 9 billion rupees ($1.9 billion) from abroad as loans or grants from foreign governments or international organizations, and as foreign private investment.

From the outset there were doubts as to whether the available resources would be adequate to finance the plan. The yield expected from taxation, borrowing from the public, and profits of state owned enterprises appeared to have been estimated somewhat optimistically. The

assistance required from abroad was more than three times the amount received from this source during the first five year plan and, as such, seemed to be well above what might reasonably be expected to be available. It was clear that, should these doubts become realized, borrowing from the Reserve Bank would have to be larger than planned. Even the planned amount of such borrowing seemed certain to generate inflation, since it amounted to about three times the amount of inflationary financing incurred during the first five year plan.

Moreover, the proposed total outlay was soon raised when it was estimated that the public investment program would cost at least 7 billion rupees (about $1.5 billion) more than originally planned. This was the result of price increases, inclusion of additional projects, and correction of certain underestimated items. Included was an upward revision of the foreign exchange requirements by 4 billion rupees ($840 million). In spite of this revision, the foreign exchange cost of the public investment program was estimated at only about 21.5 per cent of the total and probably remained significantly understated.[1] Resources to finance this increase were not indicated but it seemed clear that foreign sources were counted on to cover the rise in the foreign exchange requirements. This would raise the total assistance expected from abroad to 13 billion rupees (more than $2.7 billion), a sum even more unlikely to be available than the original requirement of 9 billion rupees. Although nothing was said to this effect, greater reliance on borrowing from the Reserve Bank than originally planned seemed to be implied.

While the financial feasibility of the plan seemed open to question, the objectives which it aimed to achieve seemed relatively modest. The proposed overall outlay was expected in five years to raise national income by 25 per cent, to increase per capita income by 16 per cent, and to create only about as many new jobs as there would probably be new entrants to the labor force. No attempt was to be made in this plan to reduce the large amount of unemployment and underemployment which have plagued India for a long time.

It seemed reasonable enough to undertake merely to prevent any further increase in unemployment and underemployment even though it was known that this would call for the creation of nearly twice as many new jobs as the first five year plan was thought to have created. The projected rate of growth of national income also seemed reasonable in the light of the employment objective. It is true that this rate of growth exceeded the rates achieved by the developed economies of the west. However, since unemployment was understood to have increased during the first plan in spite of an increase in national income of nearly 18 per cent,

1/ The import content of development programs of underdeveloped countries has frequently been around 50 per cent of the total cost of the program. In some cases, it has been higher.

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it was thought that the attainment of the employment objective would require a more rapid rate of growth than was achieved in the first plan. The apparent ease with which national income was raised by 18 per cent during the first plan made it seem as though the rate of growth projected for the second plan would be attainable. The relatively modest nature of the objectives was given as a justification for disregarding the warnings about the financial feasibility of the plan.

While these objectives might have been sought with a somewhat smaller outlay, the Indian authorities desired to lay the basis for future development by making a special effort to expand heavy industry. Since this did not involve the creation of much additional employment in relation to the outlay involved, it was decided to stress handicraft and small scale production of consumer goods, at the expense of factory production of these goods, in the belief that this would make up the deficiency in job creation. Both of these decisions had the effect of raising the outlay needed to bring forth the desired addition in total output. The expansion of heavy industry required large amounts of capital, while handicraft and small scale production of consumer goods was relatively less efficient than factory production.

As had been feared, the attempt to carry out this plan and the resulting boom in private investment and consumption brought on a sharp increase in inflationary pressures. The growth of public and private investment spending increasingly financed by Reserve Bank advances to the Government and by bank credit expansion boosted money incomes. The resulting increase in effective demand outstripped the rise in domestic production so that prices rose, imports increased sharply and foreign exchange reserves began to fall rapidly.

Fiscal policy

The public investment program extended and intensified the public investment activities of the first five year plan. It involved rapidly rising public expenditures, as a result of which the budget deficits, which had begun to grow in the latter part of the first five year plan, grew further.

A courageous attempt was made to increase revenues through taxation. Excise duties on cotton cloth were raised in September 1956. A supplementary budget, adopted in December 1956, revived the capital gains tax which had been in effect briefly after World War II and raised the dividend tax and certain import duties. At the same time, businesses were required to deposit with the Reserve Bank sums equal to specified percentages of their depreciation and other company reserves. The 1957-58 budget, adopted in August 1957, raised a number of excise and import duties as well as certain postal rates, increased the corporate income tax rate, cut sharply the exemption level on the personal income tax, and introduced a new tax on railway fares, a wealth tax, and a personal expenditure tax.

Including tax increases adopted by several of the States of the Indian Union, these various measures are estimated to yield an additional tax revenue of about 1.5 billion rupees ($315 million) per year.[1]

In spite of this, the combined operations of the central and state governments continued to yield increasingly large deficits. Although non inflationary means of financing (e.g. borrowing from the public and foreign assistance) yielded growing amounts these were not enough to prevent a sharp rise in inflationary financing, principally government borrowing from the Reserve Bank of India. As shown in the following table, the inflationary impact of government activities, which was negligible in 1953, grew sharply each year thereafter until, in 1957, it was estimated at 4,680 million rupees ($983 million), about 90 per cent larger than in 1956, nearly three times the 1955 rate, and nearly seven times the 1954 rate.

Table 1

Inflationary Impact of Government Operations in India since 1953[2]
(In million dollars equivalent)

	1953	1954	1955	1956	1957
Reserve Bank credit to Government	-81.5	- 2.9	+228.5	+566.2	+904.5
Scheduled bank holdings of government securities	+26.9	+ 25.0	+ 78.1	- 42.8	+143.4
Other bank claims on Government	+ 1.9	+ 4.6	+ 12.2	+ 3.6	- 31.0[3]
Government currency circulation	- 6.3	- 4.2	+ 12.6	- 4.8	- 25.0[3]
Government rupee balances[4]	+97.4	+122.6	+ 14.7	- 6.5	- 9.0[3]
Net inflationary impact	+38.4	+145.1	+346.1	+515.5	+982.9[3]

Source: Reserve Bank India Bulletin (various issues)

Monetary policy

At the same time, a monetary policy of controlled expansion was adopted toward the private sector. Under this policy, credit for productive purposes along lines consistent with the five-year plan was allowed to expand, while credit for speculative purposes was curbed. The principal

1/ The personal expenditure tax did not become effective until April 1, 1958.
2/ Change measured from figures as of last friday of year.
3/ Estimated.
4/ Increase: - ; decrease: + .

restraining instrument of the policy was a regulation applying to advances against foodgrains, sugar, and, for a short time, cotton textiles. With respect to these advances, the regulation set the maximum percentage of the value of the collateral which banks would be allowed to lend and fixed ceilings on the total of such loans as well as on individual advances.

This policy of selective credit restraint, first introduced in the spring of 1956, was reinforced, in August 1957, by a request to the banks from the Governor of the Reserve Bank that they bring down the overall level of advances by 10 per cent by mid-October from the level of early August. It was understood that banks which did not do so would find it more difficult to borrow from the Reserve Bank when the next seasonal increase in the demand for credit got underway. The banks were told to comply without reducing credit to the productive sector, in a continued attempt to limit the applicability of the restraining action to speculative activity.

A further measure of restraint was introduced by moderate increases in the Reserve Bank lending rates to banks. There were four such increases between March 1956 and May 1957, and the overall result was to raise the lowest lending rate from 3 to 4 per cent. However, the effect appears to have been limited. While the higher rates brought about some tightening of the money markets, the liquidity of the banks was never so strained as to retard significantly the growth of advances. In part this is because the growing recourse by the Government to borrowing from the Reserve Bank bolstered bank liquidity at an increasing rate. But in addition, the Reserve Bank increased its credit to the banks by 805 million rupees from March 1955 to March 1957, nearly tripling it. This provided the basis for more than 40 per cent of the 2,839 million rupee expansion in bank credit which occurred in these

two years.[1]

Since early in 1957, bank liquidity has been further bolstered by a substantial accumulation of rupee funds in commercial banks to the credit of the U. S. Government as the Indian Government began paying for U. S. surplus agricultural commodities imported under a PL 480 agreement.[2] The banks appear to have used the bulk of these funds to

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1/ The calculation is based on these facts: for several years, about two-thirds of additions to money supply each year have taken the form of currency, and about a third has been in bank deposits. For scheduled banks, each year in the last several years, about 60 per cent of additions to bank deposits have been in demand deposits and about 40 per cent in time deposits. Scheduled banks are required to maintain balances at the Reserve Bank equal to 5 per cent of demand liabilities and 2 per cent of time liabilities. Given the 60-40 ratio of demand and time deposits, this means that the effective overall reserve ratio for scheduled banks is about 3.8 per cent, (i.e., 60 per cent at 5 per cent and 40 per cent at 2 per cent). For cooperative banks, the effective overall reserve ratio works out at about 1.7 per cent. The rise in Reserve Bank credit of 805 million rupees in two years may be broken down into a 661 million rise in credit to scheduled banks and a 144 million rise in credit to cooperative banks. Given these facts, the expansion coefficient, A, is calculated as follows:

$$A = \frac{1}{1-(1-R)x(1-C)}$$

where R is the applicable reserve ratio and C is the percentage of leakage through increased currency circulation. On this basis, the expansion coefficient for scheduled banks is 1.465. For cooperative banks it is 1.48. The expansion of bank credit made possible by the growth of Reserve Bank advances to the banks works out at 1.465 x 661 + 1.48 x 144 = 1,187 million rupees.

2/ PL 480 provides for the disposal of U. S. surplus agricultural commodities. Under Title I of this law, these commodities may be sold for foreign currencies. The United States reserves some of the proceeds of such sales for its own uses and makes the rest available to the foreign country, partly as a loan and partly as a grant. Under a Title I agreement signed in August 1956, the U. S. is providing India with agricultural commodities valued at $360.1 million over a three year period. Of the rupees paid by India, $72 million equivalent is reserved for U. S. uses, $234 million equivalent is to be loaned to India and the balance given to India as a grant for development.

reduce their indebtedness to the Reserve Bank and to buy Indian Government bonds, and to have financed the expansion of credit[1] largely from liquidity created by continued government borrowing from the Reserve Bank. As the commodities so imported were put on the market, the Indian Government being reimbursed from the proceeds, the transaction resulted in an absorption of liquidity from the public. At the same time, the decline in reserve bank credit to the banks by nearly 30 per cent since March 1957, which was thereby made possible, involved a weakening of the influence of the Reserve Bank on the money market.

On balance, monetary policy toward the private sector appears to have been more expansionary than it was restrictive. It is true that advances against foodgrains were largely stabilized in 1957, but such advances account for only about 5 per cent of total bank credit and other advances continued to expand. Overall bank credit to the private sector, which had risen by 12.5 per cent in 1954 and by 14.4 per cent in 1955, expanded by 25.6 per cent in 1956 and by another 14.6 per cent in 1957. At the end of 1957, the level of bank credit outstanding was nearly double what it was four years earlier. Industry, particularly the iron and steel, engineering, and cotton textile industries, received about half of the additional credit granted by banks in these four years and another large share went to traders in non-agricultural commodities, especially traders in cotton textiles, and in machinery, engineering and chemical products.

Demand and supply

Money incomes rose as public and private investment spending increased. However, part of the increase in incomes went into time deposits, thereby mitigating somewhat the inflationary pressures. Between the end of 1953 and the end of 1956, time deposits of banks rose by 1,411 million rupees (about 38 per cent), but this was only about 42 per cent as much as bank credit expanded in this period. In 1957, they rose more than bank credit, but this was due to the accumulation of PL 480 funds to the credit of the U. S. Government. Excluding this factor, they rose less, although they probably offset bank credit expansion to a greater extent than in each of the previous three years.

It is not known to what extent, if any, the rising money incomes went into private hoards. Such hoards generally take the form of precious metals, which are largely smuggled into the country since their import is prohibited. It is also probable that the sectors of the economy where transactions have generally been on a barter basis are increasingly adopting money as a means of exchange. Nevertheless, it seems clear that the increase in money incomes generated a substantial rise in effective demand.

1/ The expansion of bank credit was smaller in 1957 than in 1956, both on an absolute and on a relative basis.

To some extent, the goods for which demand was rising could be and were being produced domestically. Industrial production, which had risen about 40 per cent during the first five year plan, continued to rise. In the third quarter of 1957, it averaged about 50 per cent more than in 1951. Its rate of growth, however, appeared to be relatively stable at 7.5-8.5 per cent a year in the last four years, whereas the growth of effective demand seemed to be gathering momentum.

At the same time, agricultural production rose less than 8 per cent from the crop year 1953-54 to the crop year 1956-57, the bulk of this rise being concentrated in the last year. Production of foodgrains actually fell about 4 per cent from 1953-54 to 1954-55 and did not recover this loss until 1956-57 when it exceeded the 1953-54 level by barely 1 per cent. While the production of fibers and of sugarcane rose sharply, that of tea appeared to have leveled off and that of oilseeds held well below its peak of 1954-55.

Not only did the domestic demand-supply situation appear to be getting out of balance, but in addition an increasing part of the rise in effective demand was directed toward goods that could not be purchased except abroad. This was particularly true of a broad list of capital goods needed to carry out the investment program. As a result, not only did prices rise sharply, but in addition the international payments position deteriorated.

Price developments

Wholesale prices, which had begun to rise in May 1955 after a steady decline over the previous twelve months, continued to increase in 1956. In 18 months, the rise amounted to 23 per cent and affected all commodity groups. In November 1956, food articles were about 30 per cent higher than in May 1955, industrial raw materials were about 26 per cent higher, intermediate manufactured products were 16 per cent higher and finished manufactured goods were about 8 per cent higher. The rise of wholesale food prices reflected in part the lower output of foodgrains in the crop years 1954-55 and 1955-56 than in the crop year 1953-54, but the fact that the upward trend of prices affected all sectors suggests that the increase in effective demand was largely to blame.

In 1957, wholesale prices levelled off. There was a brief spurt in May, June and July, but this was followed by a steady decline in the last five months of the year. The decline extended into 1958 and in March, wholesale prices were 1 per cent lower than a year earlier, 7 per cent lower than at their peak in August 1957. Wholesale prices of food articles, industrial raw materials, and intermediate manufactured products, in particular, were significantly lower. In part this resulted from the steady arrival throughout this period of large shipments of surplus agricultural commodities from the United States and the recovery of foodgrain production in the crop year 1956-57 to a new record level.

but, more important, it reflected the fact that the impact of inflationary pressures was being fully absorbed by the balance of international payments and the reserves of foreign exchange.

The international payments position

The balance of payments position, which had been one of approximate equilibrium in 1953, 1954, and 1955, deteriorated sharply in 1956 and 1957. The current account deficit grew steadily until, for the six months ended September 30, 1957, it ran at an annual rate of 5,956 million rupees (about $1,250 million).1/ In this six month period, the annual rate of imports was about 58 per cent higher than in the corresponding period of 1955. At the same time, exports showed almost no gain above the levels of 1955. As a result, the trade deficit rose from about 650 million rupees ($137 million) in 1955 to about 2,100 million rupees ($440 million) in 1956, and to an annual rate of about 3,485 million rupees ($732 million) in the first nine months of 1957.2/

1/ Excluding the return to the United States of large amounts of lend-lease silver.

2/ Based on customs figures. Since July 1956, the payments deficit on merchandise account has been much larger than the trade deficit recorded by the customs, reflecting the fact that heavy payments were being made for merchandise not currently being delivered. Advance payments on orders for capital goods are known to have been substantial. Most of these advance payments were undoubtedly required by the sellers, but some were probably instigated by Indian buyers, partly reflecting a flight from the pound sterling in connection with the Suez crisis. Throughout this period, India has continued to earn a surplus on invisible account.

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Table 2

Indian Foreign Trade 1954-57

Quarters	Exports: Value (In millions of rupees)	Exports: Percentage change from same quarter of previous year	Imports: Value (In millions of rupees)	Imports: Percentage change from same quarter of previous year	Trade balance (In millions of rupees)
1954 - I	1,319	- .5	1,321	- 1.0	- 2
II	1,134	- 5.2	1,520	- 7.9	-386
III	1,434	+10.0	1,595	+ 7.3	-161
IV	1,740	+16.9	1,740	+40.2	0
1955 - I	1,628	+23.4	1,709	+29.4	- 81
II	1,325	+16.8	1,624	+ 6.8	-299
III	1,611	+12.3	1,581	- .9	+ 30
IV	1,513	-13.0	1,815	+ 4.3	-302
1956 - I	1,645	+ 1.0	2,028	+18.7	-383
II	1,316	- .7	1,917	+18.0	-601
III	1,423	-11.7	2,101	+32.9	-677
IV	1,658	+ 9.6	2,101	+15.7	-443
1957 - I	1,637	- .5	2,280	+12.4	-643
II	1,455 1/	+10.6 1/	2,617	+36.5	-1162 1/
III	1,646 1/	+15.7 1/	2,455	+16.8	-809 1/
IV	1,553 1/ 2/	- 6.3 1/ 2/	2,270 2/	+ 8.0 2/	-717 1/ 2/

Source: International Financial Statistics

1/ Estimated. Official figures are believed to include shipments of silver to the United States in repayment of silver obtained from the United States during World War II under a lend-lease agreement. Adjustment made on the basis of U. S. data on receipts of silver from India under the agreement.

2/ Estimated on the basis of data for October and November only.

The increase in imports was the most spectacular manifestation of the rise in effective demand. The bulk of it represented sharply stepped up deliveries of machinery, metals, and metal products, and the arrival of surplus agricultural commodities from the United States beginning in November 1956. Imports of machinery, metals and metal products accounted for about 86 per cent of the rise in total imports from 1955 to 1956 and may explain as much as 40 per cent1/ of the rise from 1956 to 1957. These imports, largely on private account, were used primarily in the expansion of facilities and for current production. However, a significant accumulation of inventories is reported to have occurred in 1956 and the first half of 1957. The shipments of U. S. surplus agricultural commodities which appear to account for somewhat more than 50 per cent of the rise in total imports from 1956 to 1957,2/ were originally intended to build up stocks, but are said in fact to have been to a large extent put on the market to fight rising food prices.

The deterioration of the trade position was largely financed by drawing down foreign exchange reserves. Between April 1, 1956 and the end of 1957, India's foreign exchange reserves were in fact reduced by 4,486 million rupees ($942 million), more than twice the amount by which it had been planned to reduce them in the five year period beginning April 1, 1956. In addition, India drew $200 million from the International Monetary Fund in three instalments in February, March, and June 1957. Other assistance in this 21 month period totalled about $600 million, including $126 million drawn on International Bank loans,3/ about $136 million in the form of U. S. aid, and an estimated $259 million representing the value of the shipments of U. S. surplus agricultural commodities already mentioned.

The bulk of this assistance, including the IMF drawing, 80 per cent of the drawings on IBRD loans, and practically all of the U. S. agricultural surplus commodities, came in 1957. Without it, and without the very extensive utilization of foreign exchange reserves,4/ wholesale prices would surely have continued to rise in 1957. Foreign exchange reserves and foreign assistance thus acted as cushions for the Indian economy. Their availability made it possible to face the growth of domestic demand with the minimum of internal price strains. But surely it could not be said that inflationary pressures were absent in 1957 and early 1958. Effective demand had reached a level at which it could be sustained only so long as the drain on foreign exchange reserves could continue and new foreign assistance could be obtained.

Remedial measures

To deal with the growing crisis, the Indian authorities began by tightening import restrictions. Import quotas were cut January 1, 1957, for 509 relatively non-essential items. At the same time, it was announced

1/ Author's estimate.
2/ Author's estimate based on U. S. data on such shipments.
3/ Repayments of $6.5 million were also made to the Bank in this period, making net Bank assistance to India in this period $119.5 million.
4/ About 51 per cent of the total decline in reserves in this 21 month period occurred in 1957.

that, in general, import licenses for capital goods would be issued only to businessmen who either (1) secured foreign capital investment at least as high as the proposed imports, or (2) obtained credits from foreign suppliers, or (3) proposed to pay with the proceeds of loans from foreign and international lending institutions. Two types of supplier credits were specified; one provided that payment before shipment should not exceed 20 per cent of the f.o.b. price, the balance to be paid in seven annual instalments; and the other limited initial payment to 10 per cent, the balance to be paid after the project had become a going concern, instalments not to exceed the net saving or earning of foreign exchange realized through the operations of the new plant.

On July 1, 1957, the open general licenses for imports were abolished, except on certain imports from Pakistan. In addition, a moratorium on issuing new licenses was enforced during the third quarter of 1957, except for raw materials and for capital goods procured under deferred payment arrangements. Beginning October 1, 1957, the import of a wide range of consumer goods was banned and quotas for many others were cut sharply.

The effect of these restrictions was to bring about some decline in imports beginning in the third quarter of 1957. Concurrently the demand for bank credit abated somewhat since importers unable to secure licenses no longer needed funds. Inventories accumulated earlier began to be drawn down, thereby providing a cushion thanks to which the restrictions did not immediately bring about an upsurge in prices. Due to the high level of outstanding licenses which remain valid, imports may be expected to continue at a high level for some time. The bulk of these licenses is reported to be for the import of machinery and raw materials.

Besides tightening import restrictions, the Indian authorities undertook a comprehensive review of the Five Year Plan itself. They decided to reduce the physical targets in such a way as to ensure that the total public outlay on the plan would not exceed the original estimate of 48 billion rupees. They established a set of priorities for the projects included in the plan and announced that they would concentrate on what they called the hard core of the plan (steel, coal, railways, and certain power projects) and on such other projects as were so close to completion that the cost of completing them was low relative to the benefits to be derived from them. Other projects were to be implemented only as resources permitted.

At the same time a concerted effort was made to secure increased foreign resources to finance the uncovered foreign exchange cost of the hard core of the plan estimated at about 7 billion rupees ($1,470 million). So far (April 1958) additional assistance has been announced by the United States, Western Germany and Japan. In addition, the Indian authorities made clear their intention to devote the country's remaining foreign exchange holdings to the support of the plan if necessary. The minimum reserve of foreign exchange which the law required the Reserve Bank to

hold was reduced from 4 billion rupees ($840 million) to 3 billion rupees ($630 million) in August 1957, and to 850 million rupees ($178.5 million) in November 1957. Even this latest minimum may be eliminated altogether under procedures provided for in existing statutes.

Conclusion

It is too early to tell whether sufficient foreign resources will become available to finance the foreign exchange cost of the reduced plan. Even if they do, it remains to be seen whether internal inflationary pressures will thereby be fully absorbed. The past rate of spending on the plan suggests that public expenditures must rise sharply in the next three years if the projected five year expenditure total is to be reached or even approached. At the same time, there is little scope for further increasing government revenues. Under the circumstances, the Indian authorities may find it difficult to carry out their recent decision to reduce the extent to which the plan would be financed by advances from the Reserve Bank, unless foreign assistance well in excess of the amount now sought is forthcoming.

If the authorities undertake to approach the projected five year expenditure total of 48 billion rupees under the plan, internal inflationary pressures may be expected to continue and the need for severe import restrictions will remain. If on the other hand the authorities decide to bring the inflationary pressures to an end by further readjusting the plan, it may eventually be possible to relax import restrictions. In either case, however, the level of Indian imports is likely to be lower than it was in 1957.

India's biggest supplier is the United Kingdom. The rest of Western Europe considered as a unit has recently become as big a supplier of India as is the United Kingdom, largely on the strength of a large increase in imports from West Germany. Including the United Kingdom, Western Europe supplied about 50 per cent of India's imports in 1956. The United States provided only about 12 per cent of the total. Indian import cuts are likely to be made on a non-discriminatory basis since its foreign exchange shortage is a generalized shortage rather than a shortage of any one currency. Therefore United States exports may be affected about in proportion to the total decline in Indian imports.

United States suppliers of machinery, vehicles, and metals, the principal U. S. non-agricultural exports to India, have fully shared in the increase in Indian imports. In 1956, shipments of these products to India, representing about half of total U. S. exports to India, were valued at about $132 million, two and a third times as much as in 1953. They accounted for nearly twice as large a percentage of total Indian imports as in 1953, a performance almost as good as the improvement in the overall position of Western Germany as a supplier of India. On the basis of data for the first nine months, it appears that some decline in these exports may have occurred in 1957. As import cuts and the readjustment of the plan assume their full effect, further

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declines seem inevitable, but the relative share of the Indian market held by United States suppliers need not fall if the terms offered to Indian buyers, including credit terms, are kept as attractive as those offered by other suppliers. At the same time, U. S. foodgrain exports to India are likely to be maintained close to the level of 1957, as the PL 480 agreement of 1956 continues to be implemented. What happens thereafter will depend in part on whether or not a new PL 480 agreement is negotiated.

In the long run, however, Indian economic growth will provide the basis for a renewed rise in imports in which United States suppliers may share. The potential of the Indian economy is enormous and neither the Government nor the people are disposed to leave it unexploited. Progress may not, at first, be as rapid as they would like, but as they solve the many problems which confront them, particularly the population problem, and as they adopt wise policies, there is no reason why the rate of progress cannot eventually rise so that the vicious circle of poverty will at last be broken.

The Indians have a long, hard road to travel and they know it. They have begun the journey with democratic institutions and with a system of government which respects the basic freedoms of the people and their human dignity. If they can reach a satisfactory and a sustainable rate of development with these institutions and this system of government, they will probably have done more to rehabilitate this political framework in the eyes of other Asian countries than can be done by any other means.