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"CONSTITUTION AND EROSION OF INDIA'S MONETARY ECONOMY: THE CRISIS OF A REDISTRIBUTIVE REGIME"[1]

Abstract

The paper tries to challenge the conventional account of India's politico-economic development after Independence. It starts from analysing the difficulty that a former colony such as India faced, namely to constitute a polity with a sovereign currency in a world of established monetary economies. Like others, the country did not succeed in coping with this difficulty, i.e. it was not possible to constitute macroeconomic coherence being a precondition for self-sustaining income generation as well as for stabilisation without risking to entirely upset the social fabric. It is argued, secondly, that Indian governments reacted by establishing a regime that may be called redistributive. The redistributive regime had its macroeconomic rationale in serving to suppress inflation in the process of planned development. It is thus maintained, finally, that the present crisis requires to re-constitute India's monetary economy by way of a currency reform.

Independence and the problem of monetary constitution

In a macroeconomic sense, nation-building amounts to establishing a sovereign currency. I have called this the constitution problem of monetary development.[2] Monetary constitution cannot be achieved by the legal act of announcing sovereignty with respect to money supply but circumscribes a process in which domestic economic agents become willing to safeguard and generate wealth in terms of the national currency. Or expressed in more formal terms: money as the medium of deferred payments, not as the legal unit of account is crucial. For that role in asset creation a national currency competes with foreign monies and/or real wealth, such as land. The willingness to hold domestic monetary claims preconditions the extent to which macroeconomic stability is compatible with economic development in a conventional sense, i.e. accumulation plus enhancement of productive capacities.

The notion of a constitution problem points to a barrier for development that a country such as India was endowed with from her birth as a nation. The period from 1947 — 55, the transition from a colonial war economy to a formally independent nation, reveals how difficult it was to constitute a polity with a sovereign currency in a world of established monetary economies. India could not exploit her seemingly

1 Paper presented is based on a more extensive study on problems of monetary development with particular reference to India (W. Schelkle: Konstitution und Erosion einer Geldwirtschaft: Entwicklungsprobleme Indiens seit der Unabhängigkeit, DIE Berlin 1992). I would like to thank my colleagues at GDI, in particular J. Wiemann and P. Wolff, for helpful discussions.

2 Schelkle 1992, ch. 2.1.

comfortable position as a net creditor of her former colonial power, the United Kingdom. Instead of maintaining a favourable investment climate, relentless defense of the Rupee was inflicted on the Reserve Bank because of strong inflationary pressures due to war finance and the Korean boom. Although growth of national income in these years has been larger than expected, this was due to a very low level of income to begin with and very favourable weather conditions for agriculture. Indian planners felt encouraged to speed up growth through industrialisation.

India thus entered a phase of forced industrialisation, based on the famous Mahalanobis model. It is well-known that this attempt of rapid modernisation led to a severe balance of payments crisis in the mid-60s. An adjustment programme, being stipulated by the Aid India Consortium, was suspended because import liberalisation and a substantial Rupee devaluation were unsustainable as long as the fiscal authorities did not exert monetary austerity. That this was not simply a question of good-will but of political self-assertion is indicated by the fact that Indira Gandhi announced a state of emergency in 1975, just two years after the Reserve Bank of India had started to combat inflation by monetary means for the first time.[3] Such a coincidence of political and monetary austerity reveals how severe and disruptive the effects of macroeconomic stabilisation must have been if the Indian government of that time felt compelled to fall back on authoritarian rule.

It is on this background that I consider the changes in the regulatory system to have a specific macroeconomic rationale that is not taken into account by conventional appraisals. While the IMF maintains that: "From independence until the 1980s, India combined a highly dirigible approach to economic development with generally conservative macro-economic policies",[4] I regard the regulatory system that was implemented since the late 60s as an attempt to substitute for conservative macroeconomic policies. Being unable to fight inflation by conventional monetary policies without risking to entirely upset the social fabric, the Indian government tried to suppress inflation through microeconomic regulation in industry, agriculture and banking. "Stagnation since the mid-60s"[5] was part of the price India had to pay for the suppression of inflation.

This interpretation proves being decisive for the analysis of what has happened in the 1980s and thus for suggestions of what has to be done to overcome the crisis in the 1990s.

A redistributive regime and suppression of inflation

In the last section, it was stated that not intervention along with prudent macropolicy but rather intervention as a substitute for prudent macropolicy characterised the Indian regime from the late 1960s onwards. This interpretation does not necessarily imply that regulation has been consciously implemented to serve that purpose. The

3 Namely by reducing the increase in money supply from 20% (1973) to 2% (1975). For further details see Schelkle (1992, pp. 95 — 99).

4 See International Monetary Fund: India — Staff Report for the 1991 Article IV Consultation and Request for Stand-By Arrangement, October 9, 1991, p. 4.

5 This is the subtitle of a well-known book, see I. J. Ahluwalia: Industrial Growth in India, Delhi etc. 1985.

political crisis, though conditioned and fuelled by economic strains, was probably a more immediate concern. Therefore, I consider the regulatory system as a response to the legitimacy problem of monetary economies rather than to its functional requirements. It is only that economic theory may tell us ex-post that the latter has been the macroeconomic rationale of intense regulations.

For a monetary economy to be sustained it is crucial to maintain the primacy of the monetary budget constraint in the sense that reasonable stability of prices and of the exchange rate has to be pursued, normally at the expense of full employment. Such a dominance of monetary over employment considerations being hardly acceptable in relatively well-off societies, it is even less so if the population of a country is to a large extent underemployed, malnourished, or illiterate.

On that background I see a redistributive regime[6] being actively established during the 70s in order to cope with both the functional requirement of stability and the normative requirement of legitimacy. The Nehruvian programme of "equity cum growth" which already implied redistributive assignments was modified in practice by emphasising less the role of central planning but strengthening the capacity to execute and monitor redistribution.

While the industrial and agricultural regulations have been extensively discussed in the literature, to my knowledge it has not been attempted in a systematic fashion to relate them to those regulations applying in the financial sector. Nor has it been tried to interpret all three sectoral interventions as pertaining to a macro regime that was well aware of monetary constraints on rapid development.

Seen from this angle, the "Green Revolution" in Indian agriculture was meant to increase the volume to be redistributed and to neutralise an important cost-push factor for inflation at the same time. In fact, the latter seems to have been a more immediate objective in the beginning of the Green Revolution than agrarian modernisation as such.[7] Industrial regulation was intensified to an extent that left almost no element of an investment decision at the disposal of potential investors, thus seeking access to the sources of income generation and of instability at the same time. Finally, the banking sector was nationalised to get a potentially powerful instrument of redistribution and inflation control in hand. Nationalised banks brought within the realm of government programmes even that majority of Indian households living in rural areas who is marginalised by macro instability while benefiting less than proportionately from dynamic income generation.

All these regulations have been intensified, if not applied for the first time, when unprecedented rates of inflation were imminent. Industrial and agricultural regulations took place on both sides of the market and were no longer geared to monitor the level and composition of economic activity. They aimed at achieving an equilibrium of

6 The term was borrowed from K. Polanyi, Trade and Markets in Early Empires, 1957. He considers redistribution by the centre to be one of the fundamental forms of economic integration beside market exchange and reciprocity which is concomitant with centralisation of power. In contrast to Polanyi, I confine the term to monetary economies because redistributive regime assumes a totally different meaning if used for planned economies (Schelkle 1992, pp. 64 — 65).

7 See B. Dasgupta: Agrarian Change and the New Technology in India, Geneva 1977, p. 43: "The (...) strategy was, at the time of its formulation, independent of the new high-yielding varieties of seeds and would have been put into operation even if the former were not available."

goods and prices as the supposed goal of anti-inflationary policy.[8] Selective credit policy was meant to achieve the same, namely to restrict demand while promoting supply as much as possible through cheap credit. This kind of microeconomic regulation as an anti inflationary device was supposed to substitute for macroeconomic austerity while leaving the volume of real income more or less untouched. The regulatory system can therefore be understood as a (questionable) tool for macro stabilisation in the Indian redistributive regime.

A redistributive regime in general is characterised by the government budget contributing a large proportion of all nominal advances which add up to the macroeconomic budget constraint that determines the volume of income generated within the period. Government thus gets hold of a considerable amount of national income to be distributed in accordance with political objectives. To be at least potentially compatible with overall stability, monetary policy and external economic relationships have to be tuned accordingly. The money supply has to be determined as a residual to budgetary outlay; in the case of expansionary fiscal policy this implies a compensatory monetary restriction. Full convertibility and a high degree of openness would impede the primacy of budget allocation but as long as internal and external rates of return on assets are closely related such restrictions will not lead to erosion due to capital flight.[9]

But even if such a regime of a monetary economy may establish macroeconomic coherence in principle, this was not achieved in India's recent history. First, a redistributive government's intervention on both sides of the market is likely to create large distortions when rapid structural change takes place in a country's environment. This has evidently occurred in the 70s and early 80s. Even if Indian policy would have tried to comply with the dictates of the world market, it is almost impossible to adjust while all structural parameters are in transition and equilibrium the outcome of an open evolutionary process. The exigeneous events in the aftermath of the "Volcker shock" in 1982 were the first momentum of the present crisis of the Indian economy.

Secondly, industrial and agricultural regulations did merely succeed in suppressing inflation but not in removing its causes through monetary restriction. The basic flaw of this kind of anti-inflation policy is that it is not a disequilibrium between goods supply and prices but a mismatch between voluntarily held stocks of financial claims and debts that causes inflation. Consequently, inflation control has to restore a stock equilibrium implying that claims become more attractive and debts more oppressive. India's policy of suppressed inflation tried to evade this painful process. The result, however, was the opposite of what was intended, namely continual stagnation and mounting inflationary pressure.

Finally, a monetary policy that is merely the residual of budget policy is prone to fail. The Reserve Bank of India was compelled in her role as a central bank to progressively keep banks from refinance in order to compensate for an increasing

8 For this view see e.g. Reserve Bank of India, Bulletin, Bombay 1969, pp. 1905f. or idem, Report on Currency and Finance 1985 — 86, p. 11.

9 The large inflow of capital from non-resident Indians was therefore ensured as long as comparatively high interest rates, relative price stability and a guaranteed stable exchange rate for the Rupee resulted in competitive returns on deposits held in Indian banks. In the second half of the 80s, such inflows financed roughly one fourth of the current account deficits (Reserve Bank of India, Annual Report 1989 — 90, Bombay 1990, p. 132). Since the Gulf crisis and the on-set of crisis, they have become very volatile.

monetisation of budget deficits. She has almost ceded her refinance function to the large term lending institutions and has become more or less confined to a dysfunctional role, namely to act as the government's bank. She has therefore lost her capacity for monetary control. The Indian financial system is thus dichotomized into RBI and Ministry of Finance on the one side, the term lending institutions (IDBI, ICICI, NABARD etc.) and commercial banks on the other.

Along with the evolution of an economic crisis, a paradoxical economisation of politics seems to have taken place in India as elsewhere in interventionist systems. If government takes up all kinds of responsibilities, it is prone to be held accountable for all kinds of failures. Contrary to liberal critique, it seems to me that the Indian interventionist regime does not indicate a strong and oppressive state but a weak state whose legitimacy completely depends on (modest) economic success. To my understanding, it is this political-economic configuration that in the beginning of the 80s made Indira Gandhi's government try to get back some room for manoeuvre through reform of India's redistributive regime.

Erosion of India's monetary economy and the case for re-constitution

To summarize the last two sections: Endowed with a handicap from her birth as a monetary economy, namely to be a late developer, India did never succeed in setting up a coherent system of markets where the need to earn money drives economic transactions.

The crisis of the late 60s led to the establishment of a regulatory system that from a macroeconomic point of view served to suppress inflation. The result has been a lingering erosion of the Rupee as indicated by erratic outbreaks of inflation and flight out of the currency into real assets. While symptoms of crisis amass, monitoring capacities of the monetary authorities have shrunk considerably.

The adjustment process will be complex and not confined to economic issues. Despite this, I infer three key requirements for stabilisation from my analysis of a dilemma between stagnation and erosion as well as from my perception of India as a redistributive regime of a monetary economy. Two of them represent economic prerequisites:

1) The lingering erosion of the Rupee has to be stopped which is almost synonymous to breaking the dynamic of public debt.
2) A collapse of investment has to be prevented while the fiscal component of aggregate demand has to be reduced at the same time.
3) Safeguards for the vulnerable part of Indian society have to be provided, if only for the reason that otherwise an adjustment programme will fail because of popular resistance to unbearable hardships.

The first of these requirements may be called "keeping the norm of a monetary economy", the second "respecting the imperative of development" and the third "maintaining social conditions for acceptance". They provide criteria according to which the ongoing IMF assisted adjustment programme may be evaluated.

Before the stand-by-arrangement between Government of India and IMF was signed in October 31, 1991, I ventured to assess prospects of a conventional

IMF-programme concentrating on the three macroeconomic aggregates balance of payments, credit volume and state budget.[10] In my conclusions, I had been rather pessimistic:
first, because substantial devaluation of the Rupee over a protracted period had not led to a sustainable balance of payments situation;
secondly, because high interest rates due to a restrictive monetary stance would lead to epidemic break-down of over-exposed banks and firms; and,
thirdly, because the interest burden as well as the structure of the state budget (share of tariff revenue, deficits of public enterprises etc.) make fiscal restoration extremely difficult. The huge internal debt accumulated by the Government of India seemed to be in fact the crucial impediment for monetary and fiscal austerity to succeed in preparing the ground for long-term adjustment.

The IMF Executive Board approved a 20-month standby arrangement to India in an amount of SDR 1,656 million on October 31, 1991. Even before that date, the Government had implemented measures to restore macroeconomic stability, such as even further exchange rate depreciation, interest rate increases, and fiscal consolidation. In the stand-by arrangement, the external, monetary and fiscal agenda was pinned down in so called performance criteria which embody the notorious IMF-conditionality. Leaving out the quantities, they read as follows:

"The fiscal objectives of the program will be monitored through performance criteria (quarterly ceilings) on the overall borrowing requirement of the Union Government as well as an indicative benchmark on total bank credit to the general government sector (...). The monetary objectives will be monitored through performance criteria (quarterly ceilings) on the net domestic assets of the RBI, with a sub-ceiling on RBI credit to the Union Government. The external objectives are monitored through quarterly floors on net international reserves of the RBI (...)."[11]

The medium-term adjustment programme was outlined in the Indian Government's Letter of Development Policy, dated November 11, 1991, which contains a comprehensive package of measures to achieve fiscal stability and to reform the industrial, trade, financial and public enterprise sector. The most notable features in this letter's macroeconomic part (§§ 11pp.) are:

— The fiscal deficit is to be reduced substantially, in particular through privatisation and rationalisation of public sector units.
— The exchange rate is to be stabilised in nominal terms after considerable real depreciation has taken place.
— Monetary policy has been tightened to defend the external position but a selective use is intended in order to minimise adverse effects on supply.

The first review of the stand-by arrangement that has been prepared for discussion in June 1992 notes that all the performance criteria for December have been met and most of the structural benchmarks (see Annexe) have been observed. The overall assessment of the review is moderately optimistic: "The stabilization measures, together with substantial financial support from the international community, all

10 The Letter of Intent was finalised on August 27, the IMF Stand-by-Arrangement agreed upon on October 31, 1991. A Structural Adjustment Programme was sanctioned by the World Bank on December 5, 1991. For my discussion of a conventional IMF-programme for India see Schelkle (1992, ch. 6.2).

11 See IMF (footnote 4, p. 24).

contributed — much more quickly than anticipated — in restoring confidence and rebuilding a cushion of foreign exchange reserves (...). However, inflation declined more slowly than anticipated (...). The overall fiscal deficit (...) fell sharply (...). Despite efforts to tighten liquidity (...) broad money rose by 18.5% in 1991/92, well above the targeted 13% (...)."[12]

My point of departure for a critique is to notice the somewhat incoherent explanation for continuing inflationary pressures -- according to the IMF they are partly due to supply shocks, partly due to insufficiently tight financial policies — despite severe fiscal austerity. Therefore, it is important to realise in which areas the broader objectives could not be achieved: In 1991/92, real GDP growth was less (2 — 2.5%) than envisaged by the programme (3 — 3.5) and inflation higher (12.8 compared to 9%), broad money growth was well above (18.5%) the intended (13%) while reserve money growth more than met the expectations (13.3 compared to 15.5%), both investment and savings rates were lower than expected (19.5 comp. 21.5% and 18.1 comp. 18.8% respectively).[13]

Given my earlier assessment, the failure, however moderate, to achieve the targeted macroeconomic objectives as outlined above is less comforting. Persistent inflation despite relative fiscal austerity indicates a considerable volume of monetary overhang which in addition is fuelled by an unsterilised build-up of net foreign assets. Even this unexpectedly large increase in asset holdings by non-residents is not necessarily a sign of relief. It is too early to say with any definiteness whether these inflows reflect restored confidence, as the IMF maintains, or rather short-term profit motives and legalisation of black money, as I suppose.

My hypothesis is thus, that the present IMF-programme has not passed the test of the first criterion, namely "keeping the norm of a monetary economy". Furthermore, the investment performance would have been even worse had not mining and services compensated for the fall in industrial production. High interest rates are a heavy burden for Indian industry because they have on average a high proportion of external financing. In this context, the over-expansion of broad money may then tentatively be interpreted as resulting, at least in part, from distress lending by firms. Or seen from the lending side, Indian banks, instead of receiving debt service payments, may have been more or less forced to credit them. The second criterion, i.e. "respecting the imperative of development", is therefore also in jeopardy. If both is true, then the third criterion, "maintaining social conditions of acceptance", is unlikely to hold as well.

From this brief discussion of recent events, I feel borne out in my former assumption that the burden of internal (and external) debt has to be reduced as a precondition for stabilisation to be bearable without strangulating income generating capacities. And indirectly, debt reduction will also be a precondition for a more profound reform of India' s redistributive regime to be headed for. While a reduction of India's external debt depends on concessions made by bilateral and multilateral donors, the most radical measure to reduce internal debt would be a currency reform.

A currency reform would change the ratio between stocks of wealth, or its dual: debt, and income streams. The conversion rate between the old and the new money determines how much the stock of debt and nominal assets will be depreciated

12 See IMF (footnote 4, p. 3).
13 See IMF (footnote 4, table 2 p. 4).

relative to nominally fixed income streams. A currency reform thus provides relief from interest payments for net debtors as well as incentives for accumulation to (former) asset holders because of the cutback in wealth.

Three economic considerations can be put forward in favour of a currency reform: its relieving effect on government's budget, disencumberment of productive enterprises, and its provision against an eroding credibility of the national money. The question whether such a radical and drastic measure is socially acceptable and politically feasible is of course much more difficult to answer. On the one hand, it is doubtful that at present the minority government has a broad enough legitimate base to convey a currency reform which will hurt all saving households. On the other hand, neither the policy of reform during the last decade nor the protracted austerity of an IMF adjustment programme seem to be more promising on that account. A currency reform appears to be a necessary though not in the least sufficient condition for the Indian political economy to recover.

Annexe

The microeconomic and medium-term oriented elements of the IMF-programme are brought out in the "Structural Benchmarks for the First Review of the Proposed Stand-By Arrangement", which also formed the base for the World Bank's first so-called "policy-based loan" to India. By leaving out some minor points, they may be summarised as follows:

— Industrial policy is required to eliminate restrictions on large firms just because of their size, to relax control over capital goods imports and to formulate proposals for an exit policy of sick enterprises.
— Foreign direct investment should be encouraged.
— Trade liberalisation should take place mainly through a harmonised system of customs classification, and through the elimination of quantitative restrictions as well as of public sector import monopolies.
— Pricing policies should be reformed to give public enterprises greater autonomy in setting prices.
— Public enterprise reform should include a concrete plan for strengthening the Board for Industrial and Financial Reconstruction as well as a programme for disinvestment.
— Tax reform and expenditure controls to be implemented have been given the status of conditions or performance criteria for the continuation of the programme.
— Financial sector reform should reduce directed lending of banks and promote the development of capital markets.

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