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Analysis of the IMF Conditionalities in 1991 Indian Economic Crisis

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ABSTRACT

"India's post-independence development was both inward-looking and highly interventionist." India was passing a rough phase in the year 1991. The country's economy crashed down. This paper seeks to explore the economic crisis in India and the measures adopted by the Indian government to battle the same. The former portion of the paper will analyze the crisis and its cause. It will also focus on the impact of the reforms introduced by the Indian government to fight the crisis. Further, the latter portion of the paper will elucidate the concept of 'conditionality' concerning the IMF. It will examine the nature of these conditionalities and will attempt to critically analyze the purpose behind the conditionality imposed on the Indian economy in 1991.

Keywords: *IMF, 1991 Economic Crisis, IMF Conditionality, LPG, 5-Year Plan.*

I. INTRODUCTION

The tragic 1991 economic crisis found India helpless and on the verge of bankruptcy. India was losing its financial sources at a very rapid rate and was merely left with forex as to last only a few days of essential imports. To make the situation even worst, the Internation Monetary Fund (IMF) and other investors withdrew their support as their confidence in the Indian market started shaking. India was left with no other option but to pledge its gold reserve and bow down to the conditionality of IMF in order to procure their financial aid in return. These conditionalities imposed structural reforms known as LPG – Liberalisation, Privatisation, and Globalisation. The imposition of these reforms had brought drastic changes to the economy of the nation. Although the conditionality imposed by IMF assisted India in surviving the unforgettable 1991 economic crisis, the nature of such conditionality diluted the essence of this monetary institute.

(A) Pre – 1991 Condition

"Colonial rule had made India the victim of the barriers to productivity increase typical of predominantly agrarian economies."[2] In the 1950s, India's economy experienced rapid growth

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[2] Chandrasekhar, C. P. (2017, August 30). The Economy: 70 years after Independence. *International Development Economic Associates*. https://www.networkideas.org/news-analysis/2017/08/the-economy-70-years-after-independence/

in the manufacturing and investment sector as a consequence of the 2nd five-year plan, the Mahalanobis Plan. However, India's GDP was still struggling to rise as these sectors failed to improve the unemployment conditions prevailing in the country, whose majority population was based on the agricultural sector. Furthermore, reforms in the agrarian sector were much needed as landowners were making surplus by exploiting the poor tenants, leading to unequal distribution of income in the economy. Hence, India's economic plan of industrialization was failing drastically as on one hand, the land reforms though introduced, remained unimplemented, and on the other, the state was facing a fiscal crunch.

The Indo – Pak, and Indo – China War in the 1960s resulted in a sudden increase in the defense expenditure; consequently, India's dependence on foreign aid increased too. Further, the mid-1960s also saw the Green Revolution as an outcome of the twin droughts. The Green Revolution increased the productivity of the agrarian sector with the introduction of 'HYV' seeds. However, the players of the agrarian sector soon began to suffer from the unfortunate result of this strategy; the productivity growth rate started to decline, and the prices of agricultural produce began to either stagnate or fall.[3] In the year 1980, India started increasing its foreign borrowings even further, in order to control domestic inflation. As a result, the cost that it had to pay for this increase in borrowings was a massive outflow of its foreign reserves. Moreover, the oil shocks contributed to the collapse of India's foreign reserve, paving the way to the unforgettable 1991 Economic Crisis.

(B) The 1991 Economic Crisis of India

In 1991, India was battling the gravest economic crisis in its history.[4] The roots of this crisis date back to 1985 when India was facing difficulties in its balance of payments. The difficulties in the balance of payments were primarily caused by increasing imports, which led to sparse foreign reserves and an unending spiral of debts of the country.[5] Oil prices were rising tremendously in the international market due to the Iran-Kuwait war, and at the same time, India had an inelastic import of oil. Rising oil prices and inelastic oil imports resulted in a current account deficit. This also led to extensive and undesirable drainage of India's foreign reserve. At one point, the country's foreign reserve was as scarce as to last merely two weeks of essential imports.[6] On one hand, the nation was facing problems in its balance of payments; on the other,

[3] Suri, K. C. (2006). Political Economy of Agrarian Distress. *Economic Political Weekly*, *41*, 1523-1527.
[4] Anand, N. (2014). An Overview of Indian Economy (1991-2013). *IOSR Journal of Economics and Finance, 3*, 19.
[5] Kolte, A. & Simonetti, B. (2018). A Contrary View on Indian Economic Crisis of 1991. *International Journal of Creative Research Thought, 6*, 54.
[6] Ghosh, A. (2006). Pathways Through Financial Crisis: India. *Global Governance, 12,* 413-415

the nations' budget was on a large scale fiscal deficit.[7] To finance this twin deficit, India made itself dependant on external funds.[8] Along with an increasing rate of external borrowings, massive outflow of foreign reserves contributed to the nation's rising debt obligation. This further led to inflation and a classic crisis of external payments and debts.[9] India was on the verge of a debt trap.

At that time, the government was under tremendous pressure and was compelled to resort to rigid reforms as India was just a few weeks away from bankruptcy. With eroding confidence over the Indian market, investors started moving their assets out of it and, at the same time, the IMF and World Bank withdrew their financial support. Under the administration of Narsimha Rao, the Indian government was left with no option but to airlift the country's gold reserve and pledge it with the European market for an emergency loan against its balance of payment debts.[10] The airlift of the country's gold reserve did not only lead to panic, havoc, and criticism from the citizens of the nation but also resulted in a devaluation of the country's currency.[11] While the currency was devalued, at the same time, India approached the IMF for financial assistance. Engagement with IMF came with its conditionalities; a failure in fulfilling the economic reforms promised would lead to moving out of the investors from the country yet again, while on the other hand, pushing hard on such rigid structural reforms by the government would give rise to an unmanageable domestic opposition.[12] IMF imposed harsh structural reforms that the Indian government was compelled to come to terms with to acquire the loan from the IMF. The structural reforms came to be known as LPG -Liberalisation, Privatisation, and Globalisation.

II. IMF'S CONDITIONALITY – 'THE LPG SCHEME'

With a country on the verge of bankruptcy and absolutely no financial backing and support, the only option left with the Indian government was to accept and implement IMF's structural policies. Many policies were undone, establishing a new model of economic policy administering the production and trading market. The conditionality imposed by the IMF in exchange for its financial support was the LPG scheme, commonly known as – Liberalisation,

[7] World Bank. (1991). India - Structural Adjustment Credit Project - 5.
[8] Ghosh (n 6), at 414.
[9] *Ibid.* at 413.
[10] Kolte & Simonetti (n 5).
[11] Bureau. (2011, November 4). India shining, India scraping RBI buys 200 tonnes of IMF gold; alert on rice. *The Telegraph*. https://www.telegraphindia.com/india/india-shining-india-scraping-rbi-buys-200-tonnes-of-imf-gold-alert-on-rice/cid/574939
[12] Ghosh (n 6), at 413.

Privatisation, and Globalisation.[13] Liberalization is a method adopted to provide the players of the economy with a higher degree of financial freedom and to uplift the restriction posed by the license policies.[14] Privatization is the procedure that enables the transfer of ownership of public entities from the government to the private sector.[15] Lastly, globalization refers to eliminating the barriers that restrict international trade, allowing cross-border market interactions.[16] Further, to survive this economic crisis, the Indian government introduced these economic reforms in order to revive the Indian economy.[17] These conditionalities did not only alter the domestic market policies but had a significant impact on the international market interaction of India.

III. The Aftermath of the LPG Scheme

The conditionality imposed the policy of LPG, known as Liberalisation, Privatisation, and Globalisation. With liberalization, the government gradually started liberalizing trade, investments, and imports.[18] The entire scheme of licensing raj was abolished, encouraging more participation of the players of the private sector of the economy.[19] The removal of quantitative restrictions further boosted the production capacity of the economy. Further, import tariffs were reduced, and interests were also eased.[20] This policy brought an increase in the overall output of the Indian economy, ultimately boosting the GDP of the country. The second economic reform of Privatisation made the government take a step back in the production sector and encouraged the players of the private sector to step in. The role of the public sector was diluted,[21] as the Indian government started disinvesting and many public sector units were now converted into private sector units, this ultimately ensured a better performance of those public sector units that were failing to perform in their optimal capability. Furthermore, these reforms also brought the monopoly in the production sector to an end, giving rise to a healthy competitive environment.

IMF’s conditionality affected not only India’s domestic market but also altered the country's international trade policies. The introduction of the policy of globalization made the country into an open economy from a closed economy. The barriers restricting international trade were uplifted, resulting in increased factor mobility. India witnessed growth in Foreign Direct

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[13] Ravan, S. V. (2014). Impact of LPG on Indian Economy. *Prime International Research Journal, 4*, 21.
[14] *Ibid.*
[15] *Ibid.*
[16] *Ibid.*
[17] Ravan (n 13), at 23.
[18] Valerie & Sweta (n 1).
[19] Ravan (n 13), at 21-22.
[20] Ravan (n 13), at 21.
[21] Ravan (n 13), at 24.

Investment in most of the sectors as free entry to foreign investment was granted, and the policies regarding foreign trade were made more investor-friendly.[22] This reform also boosted India's attractiveness as a preferred destination of investment, which could be ascertained from the large scale inflow of FDI's.[23] Moreover, these policy reforms acted as an incentive for a massive inflow of FII's in the Indian stock market, raising the country's GDP. Furthermore, India also witnessed a growth in its real GDP from an average of 5.7% p.a. in the 1990s to a 7.3% p.a. in the 2000s.[24] These structural reforms undoubtedly helped in the growth of India's economy; however, the purpose behind the imposition of these conditionalities by the IMF was not the same.

IV. IMF CONDITIONALITY

"Conditionality may be defined as a means by which one offers support and attempts to influence the policies of another in order to secure compliance with a program of measures."[25] In the case of IMF loans, conditionality is an instrument used to secure the funds borrowed by a member country, by imposing certain macroeconomic policy reforms on them as a mandatory requirement to be met for obtaining the fund.[26] These conditionalities of IMF are mostly unavoidable by the beneficiary nation and have to be implemented in exchange for financial support from the institute. The conditions are imposed through measures such as prior actions, quantitative performance criteria, indicative targets, and structural benchmarks.[27] Furthermore, the purpose of the conditions attached to the funds primarily is to help the borrowing country overcome its external debts and resolve the crisis in its balance of payments account. These conditions also ensures that the policies of the borrowing countries are reformed in a manner as to place the borrowing country in a position to return the borrowed funds timely, thereby making these conditions a tool to secure the funds lent to the member country. Another factor affecting the conditionality imposed by the IMF is the beneficiary nation's access to financial resources; where the borrowing country has secure and stable access to such resources, it would avoid a specific policy that it deems undesirable.[28]

(A) Nature of Conditionality

The conditionality of IMF directly or indirectly interferes with the country's existing economic

[22] Ravan (n 13), at 26.
[23] Anand (n 4), at 21.
[24] Anand (n 4), at 19.
[25] Buira, A. (2008). *An Analysis of IMF Conditionality.* United Nations Publications.
[26] Cypher, J. & Dietz, J. (2009). *The Process Of Economic Development*. Routledge.
[27] Buira (n 25), at 16.
[28] Buira (n 25), at 6.

policies seeking financial support. It tends to intervene and impose changes to policies that are crucial to the economy of the borrowing country. Interference from external sources, resulting in restructuring or influencing certain economic policies of a country, through conditions makes them intrusive in nature.[29] The conditions imposed by the IMF may also be tagged as coercive, but situationally. This means the more robust access a country has to resources such as foreign reserves, and a strong economy, the better position it will be put in to negotiate the terms of policies.[30] Such countries do not have to undergo the pressure to accept and implement any undesirable policy in exchange for financial support. At the same time, countries battling critical financial crises and lacking financial backing, are more prone to get coerced by undesirable policies and reforms due to less or negligible access to resources and a crashing economy battling to survive a crisis. In situations where the cost of not submitting to the conditions is very high, the conditions become unavoidable and coercive.[31] Thus, the country seeking financial assistance in these situations is left with no other option but to come to terms with the conditions, coercive or not, in order to avoid the heavy cost of default. Moreover, the greater the need for a country, the more likely it is to be compelled by the conditionality's imposition.[32]

V. Analysis of IMF conditionality during the 1991 Indian economic crisis

The scheme of LPG was coerced by the IMF as a conditionality to enable the nation to procure the funds.[33] The reforms undoubtedly benefitted the country's economy to great lengths; however, this benefit was consequential and not a primary motive of the IMF. As stated by Feldstein, the desperation of a nation seeking financial assistance does not give IMF a moral right to use it as an opportunity to impose fundamental and structural reforms as per its technical judgments; the sovereignty of such countries shall be respected, no matter however useful the conditionalities may be in the future.[34] India's financial crisis was used as an opportunity to uplift the barriers that restricted international trade by imposing reforms such as globalization. India's desperation and lack of financial backing compelled it to bow down to the conditionalities, irrespective of its desirability. This resulted in India's sovereign rating becoming futile[35] moreover, the government faced much criticism for surrendering the

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[29] Buira (n 25), at 4.
[30] Buira (n 25), at 4.
[31] *Ibid.*
[32] *Ibid.*
[33] Kolte & Simonetti (n 5), at 63.
[34] Feldstein, M. (1998, March). Refocusing the IMF Foreign Affairs. *Current Affairs.* https://www.foreignaffairs.com/articles/asia/1998-03-01/refocusing-imf
[35] Kolte & Simonetti (n 5), at 61.

sovereignty of the country to the conditionalities imposed by an external institute.[36] Furthermore, IMF conditionalities have tended to ignore the long-term growth and development of the economy of the borrowing country and are criticized for solely being demand managing.[37] Thus, the primary motive of the conditionality has always been securing the funds lent to the member country rather than focusing on the overall growth of the country's economy.

VI. Conclusion

IMF was established as a monetary institute to financially assist its member countries in overcoming their external debt payments in order to save them from defaulting. Though the conditionalities of IMF assisted India in surviving the unforgettable 1991 economic crisis, the concept of conditionality was never stated initially in the Articles of Agreement on this institute.[38] It has always been one of the most controversial elements of IMF policies and has been criticized for being short-run oriented and ignoring the long-term development of the borrowing member.[39] Further, as stated in the previous portion of the paper, these conditionalities tend to be quite intrusive and coercive in nature; this nature of the conditionalities could raise questions on the morality of IMF, as ultimately such conditions tend to disregard the sovereignty of a country. These conditionalities have also faced much criticism over the years as IMF has lost its essence and focus of acting as a body offering financial assistance to its member countries; it has forgotten its fundamental motive in the process of imposing such conditions and attempting to influence the economy of a country beyond its competence.[40]

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[36] Ghosh (n 6), at 419.
[37] Buira (n 25), at 1.
[38] Buira (n 25), at 2.
[39] Buira (n 25), at 1.
[40] *Ibid.*