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Volume Author/Editor: Jagdish N. Bhagwati and T. N. Srinivasan

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Chapter Author: Jagdish N. Bhagwati, T. N. Srinivasan

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Part III

Liberalization Episode

Chapter 5

The Dimensions of the Liberalization Episode

By the time of the devaluation in June 1966, the government's efforts at liberalization had gathered some momentum. None of them, however, yet represented anything more than partial and halting measures. In particular, the exchange rate remained overvalued: import premia remained high and export subsidies had steadily been mounting to offset, however inefficiently, the adverse effects of the overvaluation on export performance. In fact, with the Indo-Pakistan War in late 1965 and the suspension of aid thereafter, the shortage of foreign exchange and the resulting rise in import premia had become serious.

The major motivating factors underlying the decision to devalue were twofold: (1) the adjustment of the parity in a situation of overvaluation seemed to fit in rather well with the government's earlier, slow attempts aimed rather at reducing the ill-effects of the overvaluation of the parity by offsetting measures such as export subsidization; and (2) more important, the Aid-India Consortium had virtually made a major devaluation a precondition for the resumption of aid, leaving the government little maneuverability because of the acute shortage of foreign exchange.

These two factors bear critically on both the policy package that went with the devaluation and on the outcome of the policy package. The fact that a major impulse behind the devaluation was the growing realization that the export subsidies and tariffs were only an inadequate and inefficient substitute for the formal parity change that was called for, meant that the government desired the devaluation primarily to substitute for the existing measures. Hence the degree of the devaluation was to reflect mainly the *existing* levels of export subsidization and *only partially* to go beyond that. The formal parity change was therefore accompanied by a substantial elimination of the export subsidies and a significant reduction of the tariffs that had been increasingly used during Phase II in lieu of devaluation. The pressures applied by the aid donors to bring about the parity change, with the continuation of aid (at the normal levels prior to aid suspension in 1965) made presumably conditional on devaluation, also meant that another major aspect of the policy change was supposed to be a significant rise in the immediate availability of aid-financed imports, accompanied by an official commitment (in principle) to a policy of liberalized imports.

The full *policy package,* as we shall hereafter describe it, consisted of (1) the formal parity change resulting in a devaluation of the Indian rupee; (2) a substantial elimination of the export incentives on non-traditional exports, a simultaneous imposition of countervailing duties to offset the devaluation on traditional exports where oligopolistic competition from rival suppliers was expected (as on tea) and a significant reduction of the high import duties; and (3) a significant increase in the availability of aid-financed imports, accompanied by official declaration and implementation of a policy of liberalized import licensing.

In evaluating the outcome of the "liberalization episode" (in the Bhagwati-Krueger terminology) that this policy package constituted, we will also have to take into account the following factors:

1. an early revival, already in 1966, of subsidization on the export of major non-traditional exports;
2. a second, disastrous agricultural drought in 1966–67, which led to wage-good-scarcity-induced price increases;
3. a resulting deceleration in monetary expansion and in fiscal expenditures during 1966–67, which reflected fears of adding otherwise to the price increases;
4. a similarly motivated shift in the composition of fiscal expenditures temporarily away from capital to current expenditures; and
5. a massively adverse political reaction to the devaluation, largely in view of its having been widely regarded to be a result of pressures exercised by the Aid-India Consortium.

In the analysis that follows, we begin in Chapter 6 by quantifying the net devaluation when the parity change has been adjusted for the simultaneous removal of the export subsidies in the shape of the import entitlement schemes, the imposition of countervailing duties on traditional exports and the reduction of import duties. In Chapter 7, we then trace the different kinds of export subsidization that did carry over from the pre-devaluation period and the important new subsidies that were introduced in the post-devaluation period; and we attempt quantification of these subsidies, essentially to develop very broad orders of magnitude. Then it is possible for us to analyze carefully the different dimensions of the economy: price level and economic activity in Chapter 8 and export performance in Chapter 9. Since the role of the Western aid donors in bringing about the devaluation was critical, the political implications of their involvement as well as their interaction with the outcome of the liberalization episode are discussed in Chapter 10. Finally, several major lessons—for India, for developing countries and for donor-developed countries—are drawn together from this analysis in Chapter 11. The relapse of the economy into Phase II by 1968–70, rather than its transition to Phase IV, is also noted there.