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Chapter 11

The Liberalization Episode: Evaluation and Lessons

In light of the analysis in chapters 6 through 10, what can we conclude about the success of this liberalization episode, and what lessons can we draw from it regarding the prerequisites of a successful liberalization package?

WAS THE LIBERALIZATION EPISODE SUCCESSFUL?

In deciding whether the liberalization episode was successful, we need to distinguish sharply between the way it was regarded by public opinion, including elite opinion, and an objective appraisal of the results in relation to the aims of the liberalization effort. These two different ways of judging the outcome are important to distinguish because the undertaking was a *complex* of policies. In consequence, it was difficult to assess and its objectives were not clearly understood. We now examine (1) the objectives of the package, (2) how far they were achieved in practice, and (3) what the general assessments are.

The Objectives.

The June 1966 policy reforms appear to have had the following objectives, in the main:

1. the replacement of the inefficient *de facto* devaluation by a *de jure* devaluation; and

2. the reduction, through the net additional devaluation plus import liberalization, of the adverse impact of the QR-regime on export performance.

Of these two objectives, the emphasis in the official pronouncements seems to have been on the former. The theme that the export subsidization programs were inefficient and needed to be replaced by a formal devaluation was repeatedly stressed. On the other hand, official pronouncements also promised an improved export performance, clearly basing this on the net devaluation which had been built into the June 1966 package, as well as on the improved availability of aid for raw material imports *and* on the theme that even the replacement of the subsidies by a formal devaluation would, in the longer run, give more stable incentives for export promotion.

3. It is not equally clear whether the government also intended to usher in import and industrial licensing policies that would have provided a more efficient set of incentives for the *pattern* of import substitution. In the beginning the "import liberalization" apparently *was* conceived to imply not just additional availability of raw material imports (on AU licenses); there are some indications that the principle of automatic protection by means of the indigenous availability system was also expected to be steadily dislodged. Industrial licensing policy, as we saw in Chapter 5, was also being amended in favor of more extensive de-licensing of industries. It seemed, therefore, as if the June 1966 policy changes were intended, in themselves and in the overall context of ongoing changes in industrial licensing, also to (a) reduce the reliance on QRs through improved export performance and (temporarily) increased availability of aid, (b) reduce simultaneously the element of automatic and indiscriminate protection that had resulted in a chaotic pattern of import substitution, (c) increase the element of competition by permitting freer domestic entry in the de-licensed industries and greater role for imports, and finally to (d) improve export performance also by making investment and production responses to export incentives more readily possible than under the cumbersome licensing procedures.

Were They Achieved?

We can therefore judge the outcome in terms of these three sets of objectives. In these terms, the liberalization episode must be described as less than successful, at best, and as bordering on failure when the credits and debits are totaled up.

1. The replacement of the *de facto* by the *de jure* devaluation was clearly accomplished in the very act of the June 6, 1966, policy announcement. As we have noted, the import duties were reduced and export subsidies were removed on that date. But, in the long haul, the intended reform of the trade and payments regime was not achieved, resulting in a lapse into

Phase II, as the cumbersome complex of multi-sided and selective export subsidization was revived (as noted in Chapter 7). The rationalization of the export subsidy situation was extremely short-lived indeed! It would appear that, with the overvaluation of the exchange rate still continuing after June 1966—the import premia still continuing to obtain on the overwhelming bulk of imports, at sizable levels, and the exchange control mechanism, therefore, still occupying its central role in the regime—the logic in favor of export subsidization was indeed strong: in principle, to offset the discrimination against exports in an overvalued system, export subsidization makes sense. On the other hand, the indiscriminate, administrative selectivity and other inefficiencies of subsidization do *not* make sense; and these were indeed, as we saw in Chapter 7, to reappear, implying that the government had more or less failed in its objective of rationalizing the export subsidization schemes on a continuing basis.

2. The objective of improved export performance was indeed achieved, if one has suitably adjusted for exogenous factors such as the second agricultural drought (as in Chapter 9). This (post-adjustment) improvement was nonetheless *not* dramatic because the size of the net devaluation was significantly lower than that of the gross devaluation.[1] At the same time, the revival of subsidization of the "new" exports clearly helped: our dummy-variable analysis picks up an *overall* effect which *includes* the effect of these subsidies as well. Thus we can conclude that the *total* policy package (inclusive of export subsidization) as of, and since, June 1966 did improve export performance. However, we must stress again that this improved export performance was based, insofar as it reflected the impact of revived export subsidization, on a set of subsidy policies that were conceived purely as export-augmenting policies rather than as *efficient* export-augmenting policies. Thus, the gain in export performance was, as before June 1966, bought at the cost of inefficiency in export promotion.

3. The explicit surrender of the objective of a rationalized export subsidy system was also to be matched by the frustration of similar objectives in the fields of import and industrial policies.

(a) The improvement in export performance did help, *ceteris paribus,* to ease the restrictiveness of the QR-regime. And the increased availability of aid after June 1966 also initially helped in this direction. However, as we have already shown, the utilization of this aid was hampered by the recipient's and donors' dilatory administrative procedures and was then partly frustrated by the onset of the industrial recession.[2] In fact, the aid *authorizations* after 1966–67, whatever the reasons, were never to reach the level presumably promised as an inducement for the June 1966 reforms, thus leading to the widespread charge that the government had been tricked into these policy changes with promises of accelerated aid flows that had failed to materialize—

an outcome of great significance in determining the political success, and hence the repeatability, of such a liberalization package. Thanks mainly to the recession, however, which was largely exogenous to the June 1966 policy package, the demand for imports appears to have been effectively low enough to lead to premia levels on imports that were somewhat lower than in the period prior to devaluation.

This is apparently true for both EI (traders') imports, as illustrated by premia on selected items in Table 11–1, as well as for the more substantial AU imports which went directly to the producers.[3] This effective reduction in the restrictiveness of the QR-regime, however, followed in large part from the recession which, according to our analysis, was a result of drought-induced fiscal and monetary policies which must be construed as exogenous to the 1966 package of trade and exchange rate policy changes.

And indeed, by 1967–68, as the industrial recession was giving way to a more buoyant industrial economy, the premia on several AU imports had already begun to reach higher levels. While it is not possible, in the nature of the case, to develop systematic time series on these premia because of the quasi-illegal aura surrounding the sale of imports or import licenses in the Indian context (as we saw earlier in Part II), we have been able to put together from different sources premia estimates for certain items, underlining our assertion that the premia on AU imports had begun reaching substantial levels by 1967–68 and continued to be at high levels through 1970–71 (when our study was being undertaken). Thus, copper, bronze, zinc, lead, nickel and other metal products, several steel products (such as steel wire and sheets), most chemicals, paper and paper products, glass and machinery (including ball-bearings and precision tools) had import premia ranging between 70 to 100 percent from 1967–68 to 1970–71.[4]

Thus, by 1967–68, the import liberalization did not quite match the original intentions of the government. After the devaluation and associated measures were announced, they were followed on June 21, 1966, by a press note on import policy which marked the major steps toward liberalization of maintenance imports. A list of 59 "priority" industries was soon set up, extending to about 80 percent of total organized-sector industrial production. Liberal licensing for these industries, which included several exporting industries as well, was announced so that the units in these industries would be able to meet their full requirements by merely going back to the DGTD and seeking additional import licenses. In addition, the policy was to be liberalized (in respect of IDA credits) in easing restrictions on the value of the license that could be expended on specific imports, thereby ostensibly releasing the firms from obligation to seek detailed specific permissions each time they wished to change the composition of the imports they sought. Imports in the nonpriority sectors were to continue being regulated as before. Toward the end

TABLE 11–1

Premium Rates for Import Licenses during the Pre-Devaluation and Post-Devaluation Months of 1966

(percent of c.i.f. value of imports)

		Jan.	Feb.	March	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Chemical products													
1. Drugs and medicines[a]	i)	230	205	186	245	125		62	38	45	37	40	43
	ii)				195	135		38	58	50	42		
2. Colors[a]	i)	158			189	175							58
	ii)					118							75
3. Perfumery				230					35		45	75	
Food products													
4. Dates		52			72	85		24	35	25	18		31
5. Cloves[a]	i)	540	102	105	111	138	85		75	55	40	52	65
	ii)	550					138		70		44		
Surgical goods													
6. Surgical goods E&D[b]			325					95					138
Engineering and metal products[a]													
7. Motor parts: thin walled bearing	i)	275	275		190	200	140		150	175			
	ii)				200		145		65				
8. Stainless steel	i)	275	300			330	325	250	250	160	150		
	ii)	300				350			260		160		
9. Ball bearing	i)					180				55			
	ii)									60			

10. Motor parts											
consolidated quota	i)		220		145	200	150		65	58	200
	ii)				150				70	60	
Miscellaneous											
11. Polished silver		135									50
12. Foreign tallow		175	190			155	160	145	140	140	60
13. Gum		158					138	150			

NOTE: Blanks indicate that premium information is not available.

SOURCE: The information is based on interviews with traders by Dr. V. R. Panchamukhi. The items included are essentially those going through EI licenses in the hands of traders. The quotations are *not* based on a sample survey but represent scant pieces of information.

a. Items (i) and (ii) refer to two alternative quotations under the same, broad category.

b. 'Surgical Goods E&D' refers to quotation of premium by an identical category in *Vyapar*, a commercial daily, published in Bombay and carrying such quotations with some regularity.

of 1968–69, these relaxations had begun to be tightened; and by 1970–71, the system was substantially back where it had begun, indicating a relapse into Phase II-type import controls.[5]

(b) Therefore, while the liberalization of maintenance imports did not remain on a continuing basis beyond 1968–69, the extension of the liberalization to imports that were in competition with domestic production was even shorter-lived. Those who held the notion that the policy changes of June 1966 would also effectively dislodge the principle of indigenous availability and the consequent automatic protection of domestic production were to be disabused during 1966–67 itself. It quickly turned out that there was stiff opposition from domestic producers to such import relaxation; there were active and successful representations to the Ministers of Finance and Industry to halt such imports and to restore the sheltered market. Apparently, it was easy to seduce Ministers into such action because they had long been taught to believe that *any* import substitution was good. The corollary that domestic production in any activity should not be allowed to be replaced by "scarce" imports was therefore equally difficult to purge from the policy-makers' thinking. Thus, import liberalization came to mean *merely* that the imports of non-competing goods, in the main, would be increased.

(c) The increase in industrial efficiency that was expected to result from increased competition (de-licensing of industries eased domestic restrictions on entry), was also to be frustrated. Given the continuing operation of import licensing, the fact that a firm could establish new capacity in a de-licensed industry merely meant that the detailed scrutiny and possibility of rejection that characterized all licensing procedures now applied to requests for import licenses. Access to imports, since it continued to be administratively controlled rather than through the market, was then the point at which licensing was effectively being implemented! Little of substance, in relation to effective entry, was therefore to change in the system. Hence, increased efficiency from greater competition was *not* a gain to be had, in practice, from the June 1966 and related policy measures.

(d) Finally, the expected improvement in the ability of exporters to respond to enhanced export incentives, following on the liberalized licensing structure, was stymied for similar reasons. While, as we have seen in Chapter 9, the government undertook a number of measures intended to help exporters get around the difficulties and obstacles that the licensing machinery created for them in the first place, there is plenty of evidence from interviews that, in matters such as product design changes and expansion of capacity, the bureaucratic procedures and delays were continuing, contributory factors in reducing the responsiveness of exports to improved prices.[6] Thus gains on this account, while probably positive, appear to have been relatively small.

On balance, therefore, the basic objectives of the policies which peaked in the June 1966 set of measures do not appear to have been achieved to a significant degree.

Public Perceptions.

Curiously enough, the public evaluation, including that among financial commentators and not merely among the political and bureaucratic elite groups, appears to have been dominated by quite the opposite criteria! The "rationalization" of the trade and payments regime was hardly considered and was implicitly either disregarded or not understood. On the other hand, the success (or rather the failure) was judged essentially by reference to the presumed effect of the policy package on export performance and on the price level. In addition, the political circumstances surrounding the policy announcements were critical, and the policy of increasing aid flows on condition that the policy changes be implemented seems to have created expectations that were not to be fulfilled. Furthermore, some concern about the impact on the terms of trade was expressed. Surprisingly, while economists would naturally worry about the possibly deflationary (immediate) impact of an LDC-type devaluation,[7] public evaluation of the industrial recession that followed June 1966 does not seem to have *attributed* the recession to the liberalization policies. We take up each of these strands for more detailed comment now.

EXPORT PERFORMANCE

The public view of export performance, we must conclude, was deeply affected by the fact that total earnings failed to rise and even fell marginally in the two years after the devaluation. Two major aspects of the June 1966 package and subsequent developments were ignored: (1) the fact that the net devaluation was significantly smaller than the gross devaluation, and (2) the exogenous impact (largely from the drought) on the export performance of traditional exports. We have noted already that the *objective* situation was different, and indeed more favorable, than the superficial view of the situation would lead one to believe. But the superficial views did dominate the general reaction.

PRICE LEVEL

Similarly, the *post hoc ergo propter hoc* illogic applied to the phenomenon of rising prices that dominated public consciousness in the year following the devaluation. As we have noted in Chapter 8, the objective situation again was very different, with the effect of the exogenous drought responsible for the major price rise in the system.

Political Reaction

The political response to the liberalization package was, as we have seen in Chapter 10, extremely critical. The essential weakness of the package was the fact that it was widely considered, and with much justification, to have been forced upon India by Western aid donors.

In particular, since the Soviet Union, which is also a major aid donor of India, was not associated with this change of policies in June 1966, the charge has continued to stick in the popular mind that devaluation is an "imperialist," "neo-colonial" policy. The charge has also been made in the left-wing press, from time to time, against the civil servants and Ministers who had supported the devaluation decision, that they are the saboteurs of "socialism."[8] These charges were revived in December 1971 when the realignment of exchange rates around the world forced India to take a position on her own exchange rate. The Indian decision was a compromise solution: the rupee was partially devalued so that its parity vis-à-vis the dollar actually went up. The left-wing press took the opportunity to attack those who, though over-ruled, had sensibly proposed that India should at least devalue to the same extent as the dollar.[9]

The 1971 decision on the rupee also underlined the fact that the senior Ministers were unwilling to be caught supporting any devaluation of the rupee. The majority of them, including the Minister of Foreign Trade, felt that the devaluation was a politically unpopular policy, that it might have caused the Congress party its reverses in the 1967 elections, and that it was, in any case, politically risky to be vulnerable to left-wing charges of being "soft on the Americans" at a time when American hostility toward India in the Indo-Pakistan War had made any sympathy for policies popularly associated with the United States a serious liability.[10]

In fact, even the partial degree of parity change that was achieved was a triumph of skill and ingenuity on the part of the top-level advisers. By claiming that India should link itself with sterling, and by taking advantage of the fact that the United Kingdom's decision was to reduce its revaluation subsequent to the dollar devaluation, while leaving the sterling appreciated vis-à-vis the dollar, they managed to reduce the parity vis-à-vis the dollar by the same amount as the reduction in the percentage revaluation of the sterling. Thus, in effect, the rupee was devalued vis-à-vis the *old* dollar; but, given the larger devaluation of the dollar itself, the rupee parity with the dollar actually moved up from Rs.7.50 to Rs.7.28 per U.S. dollar.[11]

The political failure of the 1966 liberalization package can thus be regarded as overwhelming: not merely did the government face a political storm over it but the political capacity to repeat such a package was damaged.[12]

Aid-Inflow and Politics

One interesting aspect of the decision by the donor countries virtually to impose liberalization on the Indian government by making continuation of large-scale aid virtually conditional on this and other changes in policies was that the policies were often to be judged in terms of how much aid actually did come in, subsequent to the devaluation. This was to work politically against the June 1966 reforms for the simple reason that, along with the general decline in aid flows during this period, the Indian aid receipts were to decline steadily.[13]

This was to lead to widespread criticism of the government by the influential press and politicians on the left, including the charge within the ruling Congress party that those politicians and economists who had accepted the imposition of these "market-oriented" and laissez-faire-type policies from the Western powers, and had hoped to be rewarded by large inflows of aid, had found that this "bribe" had not materialized and that the country had been unwittingly duped with the aid of these Indians.

It should be emphasized that (i) substantial aid did materialize after the devaluation and (ii) these Indian economists and politicians genuinely believed, and some of them had publicly argued to that effect even prior to the aid suspension and foreign pressures thereafter, that these policy changes were long overdue. These facts, however, are irrelevant to the fact that the unwise pressure on India in the general direction of measures such as those in the liberalization package had made the charges we have just described credible to vast numbers of people, and made them believe that here was one more powerful reason why the "devaluation had failed."

Terms of Trade

Among the less frequent indications of success, though one not used outside financial circles, was the effect of devaluation on the terms of trade. Devaluation is traditionally regarded as a dangerous policy because it may lead to an adverse impact on the terms of trade. In a real sense, this is a fear based on confusion. If there is no reason, such as residual monopoly power in trade, to use tariffs (or tariff equivalents such as an overvalued exchange rate), then devaluation is indeed the optimal policy for regulating external accounts. And, if there is monopoly power in trade which is not yet exercised, then the optimum tariff argument itself requires that tariffs be used to improve the terms of trade and to restrict trade, in the first place, and then devaluation be used *beyond* that for regulating the external accounts. Concern with what happens to the terms of trade, as such, is therefore quite misplaced.

Since, however, in some assessments of the devaluation, the effect on the terms of trade was regarded as important, we may examine the behavior

of the Indian terms of trade subsequent to the June 1966 devaluation. Note, of course, that the actual behavior of the terms of trade would reflect exogenous movements in the prices of traded goods abroad; also, insofar as the composition of exports and imports is likely to shift in response to a devaluation (e.g., new exports are likely to become more competitive and therefore to materialize), the movement in the terms of trade (as customarily measured) is not unambiguously interpretable.

The terms of trade index (defined as the unit export value index divided by the unit import value index) during 1966–67, taking only the ten months following the devaluation into account, actually improved from 109 in 1965–66 to 113; it rose yet further to 124 during 1967–68 (Table 11–2). Indeed, the terms of trade for 1963–64 to 1965–66 averaged 108 whereas for 1966–67 to 1969–70 the average improved to 119. Thus, by this fallacious but nonetheless influential index of failure, the devaluation in 1966 was not a failure; instead of worsening, the terms of trade actually improved.

The Recession

It is interesting that there is little evidence of the June 1966 policy changes being blamed for the industrial recession. Objectively speaking, as we have shown in Chapter 8, the fiscal and monetary policies which were, at

TABLE 11–2
Terms of Trade, 1960–61 to 1969–70
(base: 1958 = 100)

	Exports		Imports		
	Volume Index	Unit Value Index	Volume Index	Unit Value Index	Terms of Trade[a]
1960–61	100	110	128	96	115
1961–62	105	109	121	98	111
1962–63	112	106	131	94	113
1963–64	126	105	135	97	108
1964–65	132	107	146	99	108
1965–66	124	113	154	104	109
1966–67[b]	119	169	149	150	113
1967–68	122	169	166	136	124
1968–69	142	166	151	141	118
1969–70	143	171	128	140	122

SOURCE: Government of India, Directorate General of Commercial Intelligence and Statistics, New Delhi.

a. Export unit value index divided by import unit value index.

b. Covers only the 10 months following devaluation, June through April.

least in large part, responsible for the recession were exogenous to the devaluation decision and were largely the result of the fear that otherwise the drought-induced increase in the price level would be accentuated. In fact, the influence of the June 1966 policy package (plus the revived export subsidies) is likely to have been mildly expansionary in having made exportation more profitable than earlier for the non-traditional exports. Thus, in this instance, the objective reality (of, at best, a mildly favorable impact on economic activity) was fairly close to the subjective evaluation (which did not link up the policy package with the recession, in any case).

LESSONS

What principal lessons can we draw from this analysis?

1. For the *donor* countries, it seems clear that the dominant lesson is *not* to force changes in policy, particularly ones with an ideological slant in the public view, by using withdrawal of aid as the lever. This may work with countries that do not have a free press and a democratic framework; it can be nothing short of disastrous in other contexts. Above all, it can ruin the political credibility of the local groups who support these policies and thereby compromise their ability to press for a repeated application of such measures in the future.

2. For the liberalizing country itself, the implication equally is that the appearance (and, even more so, the reality) of surrender to "aid blackmail" would compromise the political success, and hence the repeatability, of a liberalization package.

3. On the *timing* of devaluation-cum-liberalization, it is clearly important, in view of the tendency to judge major policy changes in terms of *post hoc ergo propter hoc* illogic, that LDCs (which typically have their price level and exports geared to their agricultural situation) should choose a time just after a good harvest.

4. It is also clearly important not to delay the adoption of a liberalization package to a point where a large *de facto* devaluation has to be replaced by a still larger parity change. The distinction between gross and net devaluations is too subtle to be grasped except by a few sophisticated economists and it seems not to arouse excessive expectations about improvements in export performance when the devaluation looks large. At the same time, the replacement of the *ad hoc* and selective export subsidization (which must invariably flourish under a large *de facto* devaluation) becomes both difficult and liable to contradict the assessed success of any net devaluation insofar as some exports, which are uneconomical but were promoted under indiscriminate export subsidization, are eliminated by the shift to a *de jure* devaluation.

5. The impossibility of dislodging the principle of indigenous availability and the consequent survival of sheltered markets underline the plausible conclusion that it is not easy to implement a "true" liberalization designed to improve the competitiveness and efficiency of domestic import substitution when exchange control over a long period has corrupted domestic industry, bureaucrats and politicians into considering any production that competes with imports as necessarily desirable and therefore automatically superior to rival imports. It does suggest, however, that the more feasible, *and* less disruptive, approach to the dismantling of such automatic protection would be to convert the implicit into explicit tariffs and then to set a gradualistic time schedule for bringing them to uniformity around a modest rate.

6. The *resumption* of the suspended aid flow was clearly helpful; but it tells us nothing about the issue of augmenting foreign credits as part of a liberalization package. There *is,* however, one point of substance that needs to be made here. As we saw, it took time for the resumed aid flow to actually reach importers: the delays were caused at both recipient and donor ends. These delays, which could have been reduced under better administrative arrangements, were to be followed by the recession which was largely brought on by the decelerating investments and outlays by the government which dreaded the possibility that otherwise the drought-induced price rises would be accentuated further. It is clear that if aid, which was largely available for "maintenance" imports (i.e., imports of raw materials and spares), had been partly available for increased imports of (the right) food grains, aid utilization would have been more rapid *in toto* and for maintenance, as the need for a deflationary policy would have been eliminated. The net effect thus should have been greater utilization of aid, greater production and investment levels in industry, and (at worst) only a moderate, adverse impact on non-traditional exports (because the reduced depression in domestic demand would have affected, *ceteris paribus,* the improved performance of the non-traditional industries, as indicated by our analysis in Chapter 9). The net result would have been, therefore, favorable, particularly if we take into account the fact that higher levels of activity would have permitted the import liberalization to be perhaps more genuine—in a recession, it is doubly difficult to attack the principle of indigenous availability. The lessons, therefore, are that the red tape in aid-disbursement and aid-tying-by-commodity-specification are both factors that can critically affect the performance of a liberalization package; and concentration merely on the total level of aid authorization or foreign credits can be counter-productive.

7. Finally, we may well ask whether the Indian policy package could have been improved, in any fundamental regard, so as to yield better results. This is a somewhat difficult question to answer as our analysis has indicated that there were several different factors interacting on the situation and the

outcome, some exogenous and beyond control and others within the set of available policy instruments. We must therefore work at several levels of approximation. If we assume that the Aid Consortium would necessarily have made aid flow conditional on the Indian government's undertaking a devaluation, and that the composition of the aid flow was also to be suboptimal (in the sense we have already discussed in this chapter), then the only meaningful questions relate to whether (1) the government could have done better by changing the policy package (e.g., choosing a different degree of devaluation) and by choosing also a different set of fiscal and monetary policies, and (2) the government could have done better by not succumbing to the pressure for devaluation. Taking the latter question first, it seems that the economic situation had deteriorated in the aftermath of the Indo-Pakistan War of 1965 and the interruptions in aid had led to shortages of imports that were hurting the economy badly. It seems, therefore, as if the effectiveness of aid diplomacy in forcing the government to devalue was very great; and it does not seem to us that, unless the government could reasonably count on resumption of significant aid, there was any real choice in the matter at that time. If we then suppose that the devaluation had to be undertaken anyway, was it the right amount? It is possible, in retrospect, to argue that it was either too much or too little. If we assume, as we must, that the drought was to follow the devaluation, it may have been quite sensible perhaps to make the devaluation, on a *net* basis, as low as possible and to claim unambiguously that the objective of the devaluation was *wholly* to replace the existing tariffs and export subsidies, which had been levied in lieu of the devaluation, and that short-term export performance improvement was therefore not an objective of the exercise at all. This might have eased the situation politically, however slightly. On the other hand, we might argue that the decision was going to be unpopular anyway, and that therefore the objective should have been to devalue as much as possible this time itself as it would not be possible to use the instrument again in the near future! In fact, since our analysis also has indicated that the devaluation (net) did help promote exports, it is arguable that an increased degree of (net) devaluation would have led to more exports and also to greater economic activity. Against this, however, we must balance the fact that, in an inflationary situation resulting from the drought, a greater degree of devaluation would have led to price changes that might well have been politically unsettling at a difficult time. Our own conclusion is that, given the external constraint of the demand for a devaluation by the aid donors as a precondition for the resumption of large-scale aid and in view of the severe drought to follow later, the government was probably wise in having acted in a reasonably cautious fashion by keeping the net devaluation within reasonable bounds. We probably need to stress again, however, that the optimal course of action, in light of later developments, would have been rather for the Aid Consortium

merely to press for a substantial unification of the tariffs and subsidies (this was beginning to happen, as we noted in Chapter 5) and strongly urge that at a reasonable future point (after the new harvest had been reliably forecast as good) the *de facto* devaluation be replaced by a *de jure* change of parity, and resume the aid flow. This would have taken the sting out of the charges of political pressure for a change in the rate of the Indian rupee and made the transition to a better and more efficient foreign exchange regime more attractive to the policy-makers and the politicians and therefore also feasible. On the other hand, given the strong dissatisfaction that the Western aid donors felt with India's economic policies and performance, it would have been asking too much to expect them to forgo the opportunity provided by the suspension of aid during the Indo-Pakistan hostilities of October 1965 to make the resumption of large-scale aid conditional on prompt changes in Indian economic policy.

RELAPSE INTO PHASE II

In conclusion, we may note that the ultimate outcome of the attempted liberalization in 1966, which inaugurated Phase III, was a relapse into Phase II. Differential export subsidies emerged at significant levels; the QR-regime continued with high premia on several items; the principle of automatic protection was not abandoned; and industrial licensing continued in substance. The emergence from the recession around 1969–70 appears to have combined with severely declining aid levels to produce a "structural deficit" that increased import premia and the consequent stringency of QRs, a phenomenon which was to be accentuated as the economy recovered to more "normal" levels of activity in the industrial sector.

The hope that India would have moved into a liberal regime with judicious use of exchange rate flexibility (either *de facto* or *de jure*), and moderate tariffs to grant protection to industry, thereby achieving greater economic efficiency and growth, appears to have been belied although the situation in 1970–71 was somewhat better in this regard than in 1965–66.

The events on the Indian subcontinent, beginning with the crackdown by Pakistan's army in East Pakistan on March 25, 1971, the eventual influx of over ten million refugees into India's troubled Eastern state of Bengal, the staggering burden of this refugee relief and its economic and political consequences, the resulting war between Pakistan and India culminating in the creation of Bangladesh, have made it impossible for the economy to return to anything like a "normal" situation, or for the economist to analyze the recent behavior of the economy in a plausible manner.

But it is abundantly clear that, particularly with the virtual disappear-

ance of U.S. aid since the dramatic political events on the Indian subcontinent during 1971, the importance of an improved and efficient production and export performance—contingent on a successful transition to Phase III—has become even more manifest. Whether this will be understood, and whether the tools of exchange rate policy and a more efficient and less wasteful form of domestic protection will be deployed in the coming years, remains to be seen.

NOTES

1. The effect on some of the major, "new" exports was, in fact, almost negligible and even negative for some sectors, as Table 6–3 in Chapter 6 has shown. Thus, the revival of the export subsidies on these items was critical to their improved export performance.

2. The latter argument is compatible with the existence of finite, and even sizable, import premia in general because the QR-licensing regime continued to imply non-transferability of licenses as well as delays in licensing renewals.

3. In interpreting Table 11–1, however, we must allow for the fact that the period immediately preceding the devaluation in June 1966 was "abnormal" because of the suspension of U.S. aid, and several import premia were at exceptionally high levels.

4. For lack of space, we have not been able to reproduce here the import premia. However, they are available from Dr. V. R. Panchamukhi at Bombay University, on request.

5. Practically none of the cosmetics was to change; but effectively the restrictions were to be *de facto* back in operation, implying the relapse into Phase II.

6. Frankena, "Export." His chapter on design problems offers a useful discussion of such difficulties in the engineering industry during the post-1966 period.

7. See J. Bhagwati, "The Case for Devaluation," *Economic Weekly*, August 1962, pp. 1263–1266; and Richard Cooper, "Currency Devaluation in Developing Countries" (Paper No. 166, Economic Growth Center, Yale University).

8. The Prime Minister herself is exempted from this charge on the convenient assumption that she was wrongly advised; this represents nothing more than coming to terms with the reality of her lately acquired immense hold on Indian politics and amnesia regarding earlier attacks on her *bona fides* as well in the wake of the devaluation.

9. Thus, *Link* (a popular, left-wing weekly) carried the following story on December 8, 1971: "Fortunately, the suggestion that the rupee should also be revalued with the devaluation of the dollar was rejected by the Union Cabinet though some senior bureaucrats, including chief economic advisor I. G. Patel, who pleaded for it were reportedly supported by Planning Minister Subramaniam. A different viewpoint is understood to have been put forth by a section of the Finance Ministry's experts, including economic adviser Ashok Mitra. It must be said to the Finance Minister's credit that when he was called upon to give his personal opinion he opted against devaluation of the rupee. A repetition of 1965 [1966, *Sic*] was thus averted. . . ."

10. It is therefore really remarkable that the Minister for Planning, Mr. C. Subramaniam, who had been a member of the three-Minister group which advised the Prime Minister in 1966 on the devaluation, had reportedly the political courage to propose that the rupee rate be adjusted fully to maintain parity with the dollar.

11. If India had not changed its parity, the new rate would have been Rs.6.90 per U.S. dollar. This ingenious method of partially following the dollar devaluation could be put across and implemented only because few if any of the anti-devaluation Ministers could have followed the complex nature of the changes in parity rates at the time. The Prime Minister is reported to have remarked that she was out of her depth, with some claiming that the rupee had been revalued and others that it had been devalued!

12. We may note that in "Currency Devaluation" Cooper's criterion of political failure—whether the finance minister or the government falls shortly after a devaluation —is not helpful (as he himself admits). Though in this instance S. Chadhuri, the Finance Minister, did fall, he was a marginal minister anyway. The Planning Minister, Asoka Mehta, was eventually eased out, but for a whole complex of reasons. The Food Minister, C. Subramaniam, has survived, has continued to enjoy the prime minister's confidence and even advocates further devaluation. And ironically, the Prime Minister herself found that by sharpening her differences with the senior Congress bosses who had criticized her openly for her decision to devalue, she helped to bring on a struggle from which she has emerged as the undisputed leader of her party and country. In retrospect, not only did Mrs. Gandhi recover extremely well from this controversy, but she may well owe her political triumph to it.

13. See J. Bhagwati, *Amount and Sharing of Aid* (Washington D.C.: Overseas Development Council, 1970).