Devaluation of the Rupee: Tale of Two Years, 1966 and 1991

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Introduction

Since its independence in 1947, India has faced two major financial crises and two consequent devaluations of the rupee. These crises were in 1966 and 1991 and, as we plan to show in this paper, they had similar causes.

Foreign exchange reserves are an extremely critical aspect of any country's ability to engage in commerce with other countries. A large stock of foreign currency reserves facilitates trade with other nations and lowers transaction costs associated with international commerce. If a nation depletes its foreign currency reserves and finds that its own currency is not accepted abroad, the only option left to the country is to borrow from abroad. However, borrowing in foreign currency is built upon the obligation of the borrowing nation to pay back the loan in the lender's own currency or in some other "hard" currency. If the debtor nation is not credit-worthy enough to borrow from a private bank or from an institution such as the IMF, then the nation has no way of paying for imports and a financial crisis accompanied by devaluation and capital flight results.

The destabilising effects of a financial crisis are such that any country feels strong pressure from internal political forces to avoid the risk of such a crisis, even if the policies adopted come at large economic cost. To avert a financial crisis, a nation will typically adopt policies to maintain a stable exchange rate to lessen exchange rate risk and increase international confidence and to safeguard its foreign currency (or gold) reserves. The restrictions that a country will put in place come in two forms: trade barriers and financial restrictions. Protectionist policies, particularly restrictions on imports of goods and services, belong to the former category and restrictions on the flow of financial assets or money across international borders are in the latter category. Furthermore, these restrictions on international economic activity are often accompanied by a policy of fixed or managed exchange rates. When the flow of goods, services, and financial capital is regulated tightly enough, the government or central bank becomes strong enough, at least in theory, to dictate the exchange rate.

However, despite these policies, if the market for a nation's currency is too weak to justify the given exchange rate, that nation will be forced to devalue its currency. That is, the price the market is willing to pay for the currency is less than the price dictated by the government.

The 1966 Devaluation

As a developing economy, it is to be expected that India would import more than it exports. Despite government attempts to obtain a positive trade balance, India has had consistent balance of payments deficits since the 1950s. The 1966 devaluation was the result of the first major financial crisis the government faced. As in 1991, there was significant downward pressure on the value of the rupee from the international market and India was faced with depleting foreign reserves that necessitated devaluation. There is a general agreement among economists that by 1966, inflation had caused Indian prices to become much higher than world prices at the pre-devaluation exchange rate. When the exchange rate is fixed and a country experiences high inflation relative to other countries, that country's goods become more expensive and foreign goods become cheaper. Therefore, inflation tends to increase imports and decrease exports.

Since 1950, India ran continued trade deficits that increased in magnitude in the 1960s. Furthermore, the Government of India had a budget deficit problem and could not borrow money from abroad or from the private corporate sector, due to that sector's negative savings rate. As a result, the government issued bonds to the RBI, which increased the money supply. In the long run, there is a strong link between increases in money supply and inflation and the data presented later in this paper support this link.

Savings Gap as Percentage of GDP

Year	Households	Private Corporate Sector	Public Sector	Total
1950-1954	1.1	-0.4	-0.9	-0.2
1960-1964	3.2	-2	-4.8	-3.6
1965-1969	2.9	-0.9	-4.6	-2.6

Source: *Foundations of India's Political Economy.* pp 197

Budget Deficit as Percentage of Total Government Expenditure

Year	Overall Deficit	Primary Deficit	Interest Payments
1960	21.05	12.37	8.68
1965-1970	25.75	16.46	9.29
1970-1975	23.14	14.17	8.97
1975-1980	22.62	14.07	8.55
1980-1985	30.23	20.34	9.89
1985	32.13	20.57	11.56
1986	35.06	23.21	11.85
1987	33.49	20.34	13.15
1988	32.58	17.96	14.62

Source: *Foundations of India's Political Economy*, pp 192

As the following tables show, growth of M1 and M2 were quite high during the 1960s and inflation was similarly high. Through restrictions on currency trading and convertibility as well as export subsidisation and quantitative restrictions on imports, India was able to maintain its unjustified exchange rate while experiencing inflation until 1966 when it faced a severe shortage of foreign reserves.

Time Period	Inflation	M1 Growth	M2 Growth
1961-1965	5.8%	7.72%	8.14%
1966-1970	6.7%	9.05%	11.50%

Source: Data on M1 and M2 are from the source given above and the average rates are computed by the authors, inflation data is from http://indiagovt.nic.in/es2001-02/chapt2002/chap51.pdf

(In Rs crores)

Year	Exports	Imports	Deficit	Foreign Aid	Deficit minus Aid	M1 growth	M2 growth
1950	947	1025	78	-	-	-	-
1951	1106	1379	273	102.06	170.94	-	-
1952	873	1002	129	71.82	57.18	-	-
1953	813	855	42	29.22	12.78	-	-
1954	918	998	80	26.46	53.54	-	-
1955	922	1024	102	66.72	35.28	-	-
1956	977	1423	446	177.98	268.03	-	-
1957	1001	1633	632	417.38	214.63	-	-
1958	903	1424	521	537.08	-16.07	-	-
1959	1008	1515	507	464.63	42.38	-	-
1960	997	1768	771	617.40	153.60	-	-
1961	1033	1718	685	395.64	289.36	3.26%	1.85%
1962	1069	1783	714	512.33	201.67	8.81%	9.86%
1963	1241	1927	686	642.51	43.49	9.68%	8.81%
1964	1282	2126	844	791.39	52.61	8.77%	10.21%
1965	1264	2194	930	819.16	110.84	8.20%	10.23%
1966	1153	2078	925	-	-	7.32%	11.22%
1967	1193	2008	815	863.00	-48.00	6.46%	9.22%
1968	1354	1909	555	528.00	27.00	8.36%	10.69%
1969	1409	1567	158	444.00	-286.00	11.36%	13.16%
1970	1524	1624	100	340.00	-240.00	11.84%	13.25%

Source: Data on trade and foreign aid are from *India and International Monetary Management.*
Monetary growth data is from *Impacts of Monetary Policy,* Bhole, L M, pp 199.

As India continued to experience deficits in trade and the government budget, the country was aided significantly by the international community. In the period of 1950 through 1966, foreign aid was never greater than the total trade deficit of India except for 1958. Nevertheless, foreign aid was substantial and helped to postpone the rupee's final reckoning until 1966. In 1966, foreign aid was finally cut off and India was told it had to liberalise its restrictions on trade before foreign aid would again materialise. The response was the politically unpopular step of devaluation accompanied by liberalisation. When India still did not receive foreign aid, the government backed off its commitment to liberalisation. According to T N Srinivasan, "devaluation was seen as capitulation to external pressure which made liberalisation politically suspect… (Srinivasan, pp 139)."

Two additional factors played a role in the 1966 devaluation. The first was India's war with Pakistan in late 1965. The US and other countries friendly towards Pakistan, withdrew foreign aid to India, which further necessitated devaluation. In addition, the large amount of deficit spending required by any war effort also accelerated inflation and led to a further disparity between Indian and international prices. Defence spending in 1965/1966 was 24.06% of total expenditure, the highest it has been in the period from 1965 to 1989 (Foundations, pp 195). The second factor is the drought of 1965/1966. The sharp rise in prices in this period, which led to devaluation, is often blamed on the drought, but in 1964/1965 there was a record harvest and still, prices rose by 10% (Bhatia, pp 35). The economic effects of the drought should not be understated, but the data show that the drought was a catalyst for, rather than a direct cause of, devaluation.

India's system of severe restrictions on international trade began in 1957 when the government experienced a balance of payments crisis. This crisis was caused by a current account deficit of over Rs 290 crore which necessitated India lowering its foreign exchange reserves (RBI Bulletin, July 1957, pp 638). The large current account deficit was largely a result of the Second Five-Year Plan which mandated higher imports, especially of capital goods. Exports in the year 1956-1957 stagnated while imports increased by Rs 325 crores from the previous year. Another factor behind the current account deficit was the increase in freight costs due to hostilities in West Asia. Unlike in 1966 and 1991, India did not explicitly devalue the rupee but instead accomplished what Srinivasan refers to as a "de facto" devaluation by imposing quantitative restrictions (QRs) on trade rather than imposing higher tariffs.

The government used the method of QRs with varying levels of severity until the Import-Export Policy of 1985-1988. Periodically, when import prices reached a premium, the government would impose import tariffs in order to absorb the gains accruing to foreign exporters as a result of India's import quotas. The second step the government took away from free trade came in 1962 when India began to subsidise exports in an effort to further narrow its consistent current account deficit. As import prices rose, the government began to impose tariffs to increase its revenue. Ultimately, in July 1966 India was forced by economic necessity to devalue the rupee and attempt to liberalise the economy to attract foreign aid. The drought of 1965/1966 harmed reform efforts as feeding those in drought-affected areas took political precedence over liberalising the economy.

According to T N Srinivasan, the policies of export subsidisation and import tariffs adopted by the government between 1962 and 1966 were a "de facto" devaluation. Since they made imports more expensive and exports cheaper, these policies reduced some of the pressure on India's balance of payments. Following the 1966 devaluation, the government initially liberalised its trade restrictions by reducing export subsidisation and import tariffs. These actions counteracted the devaluation to some extent but even taking these policies into consideration, there was still a net devaluation and, as the trade data above show, the devaluation did stimulate exports. In the resulting backlash against economic liberalisation, quantitative restrictions and export subsidies returned, albeit at lower than pre-1966 levels.

The 1991 Devaluation

1991 is often cited as the year of economic reform in India. Surely, the government's economic policies changed drastically in that year, but the 1991 liberalisation was an extension of earlier, albeit slower, reform efforts that had begun in the 1970s when India relaxed restrictions on imported capital goods as part of its industrialisation plan. Then the Import-Export Policy of 1985-1988 replaced import quotas with tariffs. This represented a major overhaul of Indian trade policy as previously, India's trade barriers mostly took the form of quantitative restrictions. After 1991, the Government of India further reduced trade barriers by lowering tariffs on imports. In the post-liberalisation era, quantitative restrictions have not been significant.

While the devaluation of 1991 was economically necessary to avert a financial crisis, the radical changes in India's economic policies were, to some extent, undertaken voluntarily by the government of P V Narasimha Rao. As in 1966, there was foreign pressure on India to reform its economy, but in 1991, the government committed itself to liberalisation and followed through on that commitment. According to Srinivasan and Bhagwati, "Conditionality played a role, for sure, in strengthening our will to embark on the reforms. But the seriousness and the sweep of the reforms… demonstrated that the driving force behind the reforms was equally… our own conviction that we had lost precious time and that the reforms were finally our only option (IESI, pp 93)."

In 1991, India still had a fixed exchange rate system, where the rupee was pegged to the value of a basket of currencies of major trading partners. At the end of 1990, the Government of India found itself in serious economic trouble. The government was close to default and its foreign exchange reserves had dried up to the point that India could barely finance three weeks' worth of imports. As in 1966, India faced high inflation, large government budget deficits, and a poor balance of payments position.

Year	Inflation	M1 growth	M2 growth
1988	9.4%	16.5%	18.3%
1989	6.2%	18.0%	15.7%
1990	9.0%	14.3%	15.1%
1991	13.9%	22.6%	18.3%
1992	11.8%	7.1%	16.9%
1993	6.4%	18.7%	17.0%
1994	10.2%	27.4%	20.3%
1995	10.2%	11.1%	11.0%

Source: http://oldfraser.lexi.net/publications/books/econ_free/countries/india.html

India's balance of payments problems began in earnest in 1985. Even as exports continued to grow through the second half of the 1980s, interest payments and imports rose faster so that India ran consistent current account deficits. Additionally, the government's deficit grew to an average of 8.2% of GDP. As in 1966, there was also an exogenous shock to the economy that led to a sharp worsening of the already precarious balance of payments situation. In the case of the 1991 devaluation, the Gulf War led to much higher imports due to the rise in oil prices. The trade deficit in 1990 was US $9.44 billion and the current account deficit was US $9.7 billion. Also, foreign currency assets fell to US $1.2 billion (RBI Bulletin, September '91, pp 905). However, as is the case with the Indo-Pakistan war of 1965 and the drought during the same period, India's financial woes cannot be attributed exclusively to events outside of the control of the government. Since the Gulf War had international economic effects, there was no reason for India to be harmed more than other countries. Instead, it simply further destabilised an already unstable economic situation brought on by inflation and debt. In July of 1991 the Indian government devalued the rupee by between 18 and 19 percent. The government also changed its trade policy from its highly restrictive form to a system of freely tradable EXIM scrips which allowed exporters to import 30% of the value of their exports (Gupta, pp 73-74).

In March 1992 the government decided to establish a dual exchange rate regime and abolish the EXIM scrip system. Under this regime, the government allowed importers to pay for some imports with foreign exchange valued at free-market rates and other imports could be purchased with foreign exchange purchased at a government-mandated rate (RBI Bulletin, January 1994, pp 40). In March 1993 the government then unified the exchange rate and allowed, for the first time, the rupee to float. From 1993 onward, India has followed a managed floating exchange rate system. Under the current managed floating system, the exchange rate is determined ostensibly by market forces, but the Reserve Bank of India plays a significant role in determining the exchange rate by selecting a target rate and buying and selling foreign currency in order to meet the target. Initially, the rupee was valued at 31.37 to one US dollar but the RBI has since allowed the rupee to depreciate against the dollar (RBI Bulletin, November 1994, pp 1485).

What Went Wrong

Clearly, there are many similarities between the devaluation of 1966 and 1991. Both were preceded by large fiscal and current account deficits and by dwindling international confidence in India's economy. Inflation caused by expansionary monetary and fiscal policy depressed exports and led to consistent trade deficits. In each case, there was a large adverse shock to the economy that precipitated, but did not directly cause, the financial crisis. Additionally, from Independence until 1991, the policy of the Indian government was to follow the Soviet model of foreign trade by viewing exports as a necessary evil whose sole purpose was to earn foreign currency with which to purchase goods from abroad that could not be produced at home. As a result, there were inadequate incentives to export and the Indian economy missed out on the gains from comparative advantage. 1991 represented a fundamental paradigm shift in Indian economic policy and the government moved toward a freer trade stance.

It is easy in retrospect to fault the government's policies for leading to these two major financial crises, but it is more difficult to convincingly state what the government should have done differently that would have averted the crises. One relatively non-controversial target for criticism is the tendency of the Indian government since Independence towards large budget deficits. Basic macroeconomic theory tells us that the current account deficit is roughly equal to the sum of government and private borrowing. Given the fact that the household saving rate in India is quite high, most of the blame for India's balance of payments problems must rest with the government for its inability to control its own spending.

By borrowing from the Reserve Bank of India and, therefore, essentially printing money, the government could finance its extravagant spending through an inflation tax. Additionally, the large amounts of foreign aid that flowed into India clearly did not encourage fiscal or economic responsibility on the part of the government. In 1966, the lack of foreign aid to India from developed countries could not persuade India to liberalise and in fact further encouraged economic isolation. In 1991, on the other hand, there was a political will on the part of the government to pursue economic liberalisation independent of the threats of aid reduction.

These two financial episodes in India's modern history show that engaging in inflationary economic policies in conjunction with a fixed exchange rate regime is a destructive policy. If India had followed a floating exchange rate system instead, the rupee would have been automatically devalued by the market and India would not have faced such financial crises. A fixed exchange rate system can only be viable in the long run when there is no significant long-run inflation.

Chronology of India's exchange rate policies

- 1947 (When India became member of IMF): Rupee tied to pound, Re 1 = 1 s, 6 d, rate of 28 October, 1945
- 18 September, 1949: Pound devalued; India maintained par with pound
- 6 June, 1966: Rupee is devalued, Rs 4.76 = $1, after devaluation, Rs 7.50 = $1 (57.5%)
- 18 November, 1967: UK devalued pound, India did not devalue
- August 1971: Rupee pegged to gold/dollar, international financial crisis
- 18 December, 1971: Dollar is devalued
- 20 December, 1971: Rupee is pegged to pound sterling again
- 1971-1979: The Rupee is overvalued due to India's policy of import substitution
- 23 June, 1972: UK floats pound, India maintains fixed exchange rate with pound
- 1975: India links rupee with basket of currencies of major trading partners. Although the basket is periodically altered, the link is maintained until the 1991 devaluation.
- July 1991: Rupee devalued by 18-19 %

- March 1992: Dual exchange rate, LERMS, Liberalised Exchange Rate Management System
- March 1993: Unified exchange rate: $1 = Rs 31.37
- 1993/1994: Rupee is made freely convertible for trading, but not for investment purposes

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