

**ECONOMIC REFORMS AND  
THE RELEVANCE OF PROF. B. R. SHENOY**  
Mrs. Kishori J. Udeshi



**FORUM**  
of Free Enterprise

## Editor's Note

We are, indeed, delighted to present to our avid readers an excellent speech on "**Economic Reforms and the Relevance of Professor B. R. Shenoy**" delivered by Mrs. Kishori Udeshi, the former Deputy Governor of the Reserve Bank of India, and currently the Chairperson of Banking Codes and Standards Boards of India. Mrs. Udeshi was specially invited to deliver Professor B.R.Shenoy Birth Centenary Memorial Lecture under the auspices of the Economics Research Centre, Mumbai, the Indian Liberal Group and the Forum of Free Enterprise on June 4, 2007.

Prof. B. R. Shenoy made distinctive impact on economic policy debates right since the beginning of the planning era in our country. He was not just a critique of Indian planning and policy formulations, but also a very perceptive thinker, who made significant contribution to the liberal economic policy thought in the country. He was truly a great thinker and a visionary, much ahead of his times - and there were only a few in his mould who could stand up, and be devastatingly critical of the Nehruvian model of economic development during those years.

Prof. Shenoy was invariably very forceful and forthright in his analysis of the flaws and inadequacies of the Indian planning and economic policy strategy. For him controlling inflation and managing stability of the fiscal and financial system was a great passion. He was amongst a very few during those days who could vehemently oppose the concept and practice of deficit financing.

The expanse and depth of his economic thoughts and policy prescriptions transcended practically every major aspect of economics, he was completely at ease not only on matters relating to complex fiscal and monetary policy issues, but also on a

*"Free Enterprise was born with man and shall survive as long as man survives".*

- **A. D. Shroff**  
1899-1965  
Founder-President  
Forum of Free Enterprise

variety of micro economic subjects covering agriculture, industrial policy, trade liberalization, exchange control abolition, floating rupee, and so on.

It is only in the last decade and half that India has moved decisively on to the path of economic reforms that were envisioned by Prof. Shenoy, even in the midst of dominant socialistic economic planning in India during the first two decades. Had the policy makers shown the same wisdom and sagacity, which Prof. Shenoy displayed - and of course, microscopic minority of others like Prof. A. D. Shroff, the founder of the Forum - the India growth story could have become a reality way back in seventies and eighties itself! But that was not to be, and hence those happened to be truly the lost decades for India!

Viewed in that context, Mrs. Kishori Udeshi has truly performed an outstanding and scholarly task while unveiling before us how Prof. Shenoy espoused several causes *"which were contrary to the popular fashions from the 1950s to the 1970s .....* *Despite being out of the pale of mainstream Indian economic thought, Shenoy made seminal contributions to the debate of his times. What is even more significant is that Shenoy's prophetic advocacy on a number of issues relating to economic policy that are of particular relevance even today It is in this context that we have to pay homage to Professor Shenoy, the sage counselor who was way ahead of his times."*

Mrs. Udeshi has done remarkably well in selecting many hard core economic reforms of recent years, and juxtaposed them with Prof. Shenoy's various policy prescriptions from the early 1950s so that *"one can admire the perspicacity of his diagnostic skills and his erudite remedies"*. Amongst the most contentious issues of those years, a special mention must be made of "deficit financing and the foreign exchange crisis." Mrs. Udeshi

specially recalls Prof. Shenoy's prophetic words in his Note of Dissent (page 3 of the booklet).

Apart from his concerns about inflation and deficit financing, Mrs. Udeshi has also reflected elaborately on Prof. Shenoy's prescriptions on economic reforms, which was anathema during his times, but has become an integral part of economic orthodoxy of current times. Thus, his reforms agenda covered practically everything that has been implemented within the framework of liberalization, competition and globalization process initiated by the Government of India since July 1991.

Thus, Prof. Shenoy in his times had prescribed (i) bringing the Government budget into better balance; (ii) channeling more funds into the agricultural sector both under public and private investment; (iii) removing the barriers to internal and external trade; (iv) revising the industrial policy and abolishing industrial licensing and the system of subsidies; (v) scaling down drastically overall public sector outlays, even withdrawing the public sector investments from certain sectors and limiting state activity; (vi) removing exchange control and adopting a fully floating rupee; (vii) reducing taxation and balancing the budget at a vastly lower level of expenditure and investment; (ix) reviewing all economic legislation and administrative measures with a view to their abandonment or restructuring them to match the needs of a free economy. Not surprisingly, Mrs. Udeshi acclaims and acknowledges Prof Shenoy as *"the real founding father of the reforms of the past 15 years."*

We are confident that this wonderful text of Prof. Udeshi's speech will be extremely valuable to the students and teachers of economics, as well as our present day politicians and policy makers in recalling and reflecting the outstanding contributions of one of India's great economists and thinkers. At the same time, it will also inspire us to pay our humble tribute to this visionary

son of India who displayed a rare courage of conviction by fighting for the right causes in those times overwhelmed by ideologically extreme stance of socialist economic planning!

The Forum is grateful to support received from Mr. Hemant J. Vaidya for printing this booklet for public education.

**S. S. Bhandare**  
*Editor*

## **ECONOMIC REFORMS AND THE RELEVANCE OF PROF. B. R. SHENOY**

**Mrs. Kishori J. Udeshi\***

I am truly grateful to the Economics Research Centre, Mumbai for giving me the privilege to deliver the Professor B.R.Shenoy Birth Centenary Memorial Lecture. It is more meaningful to me because, he and I belong to the RBI family. Prof. Shenoy's stint in the Reserve Bank of India (1945-1953) was, according to Professors Mahesh Bhatt and Mukund Trivedi a very fruitful period of his life in terms of intellectual and professional accomplishments. While I do recall meeting Prof. Shenoy's family, when I was a child, it was only after I joined the RBI in 1965- long after Shenoy left the RBI - that I had an appreciation of his monumental contribution to Indian economic thought. His espousing of causes which were contrary to the popular fashions from the 1950s to the 1970s evokes great awe and respect. Despite being out of the pale of mainstream Indian economic thought, Shenoy made seminal contributions to the debate

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\*The author is Chairman, Banking Codes and Standards Board of India and a former Deputy Governor, Reserve Bank of India. The text is based on the Prof. B.R. Shenoy Birth Centenary Lecture delivered on 4th June 2007 in Mumbai under the auspices of Economics Research Centre in association with Forum of Free Enterprise and the Indian Liberal Group. The text is reproduced with kind permission from Economic Research Centre for free and wide distribution.

of his times. What is even more significant is that Shenoy's prophetic advocacy on a number of issues relating to economic policy are of particular relevance even today. It is in this context that we have to pay homage to Professor Shenoy, the sage counselor who was way ahead of his times.

What I propose to do is to refer to select initiatives in economic reforms of recent years and juxtapose them with Shenoy's various policy prescriptions from the early 1950s so that one can admire the perspicacity of his diagnostic skills and his erudite remedies.

### **Deficit Financing and the Foreign Exchange Crisis**

The Second Five Year Plan (1956-61) formulation period was an exciting one for economists. A panel of economists (April 1955) consisting of the cream of Indian economists was set up to draw up the Draft Plan Frame for the Second Plan. The panel was greatly influenced by the dirigiste Soviet system and most members were enamoured of the high real growth rates achieved by the USSR & the East European Countries. There was a distinct tilt towards heavy industry, which by itself was not necessarily imprudent, but the corollary was that the Second Five year Plan size of Rs.8800 crore (against a First Five year Plan of a little over Rs.2000 crore) had a component of Rs.1000-1200 crore of deficit financing. This size of deficit financing was a quantum jump. At that time the definition of deficit financing was the reliance on *ad hoc* Treasury Bills and changes in Government cash balances. If one were to use the present day definition of the "gross fiscal deficit" the deficit financing for the Second Plan was clearly staggering. Shenoy, with

his vigorous background of monetary economics, could foresee the dangers in such a large recourse to the printing press. In prophetic words he argued in his Note of Dissent on the Memorandum of the Panel of Economists, which is surely the *locus classicus* on the subject and requires to be read in full, but is reproduced here in parts:

*"To force a pace of development in excess of the capacity of the available real resources must necessarily involve uncontrolled inflation. In a democratic community where the masses of the people live close to the margin of subsistence, uncontrolled inflation may prove to be explosive and might undermine the existing order of society ... We should be therefore, forewarned of the dangers of an over ambitious plan... As no plan can be bigger or bolder than the available resources, the size of the investment programme should be reviewed periodically to ensure that it keeps within the limits of savings... The inability of the Plan Frame to place more than about 75 per cent of the resources required for the Plan under the usual sources and the reliance of deficit financing for the rest, is broad evidence that the size of the plan far exceeds the available savings... Deficit Financing is essential in an under developed economy to permit full use of the scarce real resources. By the same token, deficit financing should stop severely short of the point at which inflation begins... Inflation tends to be self-perpetuating... Once inflation begins, it tends to gather momentum and while it runs its*

*course we are apt to be, more or less, helpless witnesses. The best protection against inflation is to prevent it by keeping the investment programmes within the available real resources."*

Shenoy's Note of Dissent was a sole voice in the wilderness. Yet, ignoring his views was costly and the rest is history. What followed was the foreign exchange crisis of 1957-58 and the response to this was even more physical controls. The majority view prevailed for the next 35 years and the economy was punctuated by cycles of large deficit financing, foreign exchange crisis and draconian controls till it culminated in the foreign exchange crisis of 1991, with foreign exchange assets of the RBI falling to less than U.S. \$1 billion.

The Reforms instituted in 1991, inter-alia, put an end, to the automatic monetization of the budget deficit, put a greater focus on the gross fiscal deficit and ultimately culminated in the introduction of the Fiscal Responsibility and Budget Management Act in 2004. This Act, which puts an end to RBI financing of primary issues of public debt, enjoins the Government to eliminate its revenue deficit and reduce its fiscal deficit to 3 per cent of GDP by 2009. Similar acts have been passed by most State Governments. (23 States). So, fiscal responsibility has now become part of our legislative commitments.

It has been a long journey from reckless deficit financing to fiscal responsibility but it is unfortunate that nowhere is there an acknowledgement to Shenoy's seminal work, which, if it had been heeded, would have saved India 35 years of agony of cycles of inflation, foreign exchange crisis

and a virtual collapse of the economy in 1991. One can also imagine what would India's economic strength have been today had the Indian polity accepted Shenoy's prescriptions 50 years ago.

### **Monetary Policy in a Liberalised Environment**

From the mid 1950s, till 1991, the preoccupation of monetary policy was to moderate the expansionary impact of a fisc which had no compunctions to resorting to creation of money. As the dependence of the fisc on created money declined in the post 1991 period, the strong expansion of created money emanated from the external sector. The challenge of monetary policy today thus is in handling the expansionary impact of large capital inflows and the consequent inflation which eventually affects growth. While the RBI has competently handled the stresses and strains of conducting monetary policy, how would Shenoy have viewed the new role of monetary policy? Keen followers of Shenoy would recall his stance on "zero inflation". Basic to Shenoy's framework would be that inflation would be public enemy No.1 and he would have, in today's context, been an *inflation targeter*. He would obviously have been a monetary hawk who would have advocated an active and aggressive monetary policy. In all probability, Shenoy would have focused on early action to keep inflation under control and tackled capital flows, forex intervention and sterilisation as an inevitable corollary of the basic stance of fighting inflation. In sum, Shenoy's views would be in sync with today's monetary policy.

As we look at the current situation there is still an advocacy of the stance that a somewhat accommodative monetary policy would enable us to eke out a higher real rate of growth and that a higher inflation rate may be a price worth paying. To those who still see a trade off between growth and inflation, it would seem that they still need to learn the lessons taught by Shenoy.

### Shenoy's Prescriptions on Reforms

According to Shenoy the first essential reform is to put a stop to inflation. In the absence of this reform, other corrective measures would not produce any noticeable impact. The prerequisite is, according to him, to first bring the Government budget into better balance. The other steps outlined by him were:

- (i) Channeling more funds into the agricultural sector both under public and private investment,
- (ii) Removing the barriers to internal and external trade,
- (iii) Revising the industrial policy and abolishing industrial licensing and the system of subsidies,
- (iv) Scaling down drastically overall public sector outlays, even withdrawing the public sector investments from certain sectors and limiting state activity.
- (v) Removing exchange control and adopting a fully floating rupee,
- (vi) Reducing taxation and balancing the budget at a vastly lower level of expenditure and investment,

- (vii) Reviewing all economic legislation and administrative measures with a view to their abandonment or restructuring them to match the needs of a free economy.

If we look at the post 1991 economic reforms we should surely be hearing the reverberations of Professor Shenoy's agenda for reform. Sadly, we appear to continue to treat Shenoy as a heretic and there is no acknowledgement to him as the real founding father of the reforms of the past 15 years.

### Shenoy's Critique of the **Industrial** Policy

Shenoy held that an indiscriminate import substitution policy withdrew resources away from the traditional and other export industries. Exports remained semi-stagnant while larger imports were needed to keep the wheels of production moving and this, according to him, was the link between indiscriminate import substitution and balance of payment difficulties. His view was and I quote:

*"The attractiveness of the overseas markets cannot return to norm, unless exporters receive the full rupee worth of their export earning, so that they may not find that to cater to the home markets was more remunerative. Exporters will not receive the full rupee worth of their export earnings unless the rupee is devalued to the equilibrium level, or in a background of continuing inflation, the rupee is floated."*

Let me switch to the current scenario. In an address at a public seminar organized by the Institute of South Asia

Studies in Singapore in November 2006, RBI, Deputy Governor, Dr. Rakesh Mohan stated:

*"Over a period of time through the 1950s, 1960s and 1970s the economy had become over controlled and rigid; consequently entrepreneurship was heavily constrained. The import substituting inward looking development strategy that could have been relevant in the 1950s was no longer suitable in the modern globalizing world. Hence overall reform had to be undertaken to lay down a new framework".*

Massive deregulation of the industrial sector, in fact constituted the first major package of reforms in July 1991. The obsolete system of capacity licensing of industries was discontinued; the existing legislative restrictions on the expansion of large companies were removed: phased manufacturing programmes were terminated; and the reservation of many basic industries for investment only by the public sector was removed. At the same time restrictions that existed on the import of foreign technology were withdrawn and a new regime welcoming foreign direct investment, hitherto discouraged, with limits on foreign ownership was introduced. With these massive reforms introduced in one stroke in 1991, the stage was set for a policy framework that encouraged new entry introduced new competition, both domestic and foreign, which thereby induced the attainment of much greater efficiency in industry over a period of time.

The Indian corporate sector has gone through significant technical and financial business process reengineering on

its own and a competitive company can now be found in almost every industrial sector. It is again apt to quote Professor Shenoy here:

*"In a free society because of the discipline of a most ruthless consumer, the management under the duress of survival, has to keep a continual watch over cost, quality and turnover. This calls for perpetual flexibility of decisions...It is just not practical to achieve the requisite decision flexibilities under social ownership i.e. the ownership of no one in particular - of 'the means of production. Experience has shown that the magic of ownership is among the most powerful forces making for progress."*

Is Professor Shenoy's stand not vindicated?

### **External Sector Reforms, Exchange Rate Management and Liberalisation of Exchange Controls**

Among the first reform moves in 1991 was devaluation of the exchange rate and a move of the exchange regime from that of a crawling peg towards a market determined one, albeit a managed exchange rate. The exchange rate regime now focuses on management of volatility without a fixed rate target and the underlying demand and supply conditions are meant to determine the exchange rate movements in an orderly way.



The trade regime too has undergone massive change with the removal of quantitative restrictions along with the rationalization of the tariff structure.

From the beginning of the reform period in 1991, the exchange control measures were being gradually liberalized. Some of the more important measures are as follows:

- (a) Replacement of the earlier draconian FERA (1973) by the market-friendly FEMA (1999).
- (b) Adoption of convertibility of rupee for current account transactions with acceptance of Article VIII of the Articles of Agreement of the IMF in 1993.
- (c) De facto full capital account convertibility for non-residents and calibrated liberalization of transactions undertaken for capital account purposes in the case of residents.
- (d) Major delegation of powers by RBI to Authorised Dealers to release foreign exchange for a variety of purposes.
- (e) Residents are now permitted to remit abroad upto U.S. \$ 1,00,000 per financial year and Mutual Funds are permitted to invest abroad upto U.S.\$ 4 billion.
- (f) Indian corporates are permitted to borrow invest and acquire assets abroad upto 300 per cent of net owned funds, which is very liberal.

Professor Shenoy's analysis of the root cause of the weakness of the Indian rupee, set out in 1968, reflects his

perspicacity in analyzing problems and some of his views are of direct relevance even to-day. For instance, he says:

"The essential point is that the strength of the currency depends on the export position and the latter provides the basic index of the strength of the currency... For the export position of a country to be deemed strong, the expansion of its exports must at least keep pace with the expansion of the national product... When, however, the export position of a country is strong, though, in the early stages of development it may import capital, as the economy develops it is apt to repay more than borrow afresh and eventually become a capital exporter."

In the context of the 1966 devaluation, Shenoy felt that the Rupee needed to be devalued to its equilibrium level and the Rupee should be allowed to float so that it would remain at the equilibrium level. Recognising the practical difficulty of arriving at an equilibrium exchange rate he argued for a floating exchange rate. To him, what was paramount was non-inflationary fiscal-monetary policies.

One wonders what Prof. Shenoy's view would have been on the recent large appreciation of the Rupee with Indian inflation rates well above those of the major industrial countries and Indian interest rates well above international interest rates. Would not Shenoy have felt the Rupee appreciation as being against fundamentals and against the interests of the economy?

## The Gold Problem

From as far back as 1939 till 1991 there had been a ban on the export/import of gold and the policy approach was to discourage the holding of gold by Indian citizens. Shenoy had, for many years, argued on the futility of the Government's approach on gold. He argued that, despite the legal restrictions large quantities of gold continued to be smuggled into the country and that this gold was costing us much more in terms of foreign exchange than it would if the gold has been purchased through official channels at the international price of gold. Despite his persuasive arguments, the Indian authorities continued to ban the official gold trade. The first change in official policy on gold came with the 1991 Policy Reforms wherein non-resident Indians coming to India were allowed to bring into India 5 Kgs of gold per person subject to payment of import duty. It was soon found that this was not a practical solution. In the path-breaking budget of February 1992, the then Finance Minister announced the intention to set up a Gold Bank by the RBI which would undertake various types of operations in gold. It is rather unfortunate that despite the budget announcement the proposal was aborted. It bears recalling that Shenoy had as far back as 1963, come up with a detailed proposal to set up a *Gold Exchange Bank* which would undertake official purchases and sales of gold. According to Shenoy's proposal a 100 per cent government controlled company could be floated which would be authorized to buy and sell gold on their own behalf or on behalf of their clients and it would be permitted to do banking business and be designated as an Authorised Dealer by the RBI. Needless to say the authorities did not pay heed to Shenoy's proposal.

It was as late as in 1997 that the authorities significantly liberalized gold imports through designated banks. Although the 1992 budget proposal to set up a Gold Bank as a subsidiary of the RBI does not have much merit now, there is still merit in allowing banks to set up a dedicated Gold Bank which would not only import/export gold but also develop various gold derivative instruments. I am referring to the issue of the Gold Bank in some detail as it once again illustrates how Shenoy's thinking was way beyond his own times.

## Justification for Increased Resource Allocation to Agriculture

Shenoy's stand throughout has been that agriculture stands neglected in our Plans and that only lip-sympathy is paid. According to a paper brought out recently by the Consortium of Indian Farmers Associations, the outlay for agriculture and allied sectors, including irrigation has dropped from 34 per cent of the total Plan outlay in the First plan (1951-56) to a mere 10.6 per cent in the 10th Plan.

Shenoy argued that the most important problem of the Indian economy is poverty and unemployment, Indian national interests would be best served if we give priority attention to agriculture. It is a sad reflection of our times that now, almost 50 years later, it is publicly admitted by the Government and other authorities that agriculture is the key significant area that has not been subject to comprehensive reforms leading to deceleration in agriculture growth and that "this deceleration has clearly had a significant impact on slower reduction in poverty levels than otherwise would have been the case."

"Unlike other economists of his times, Shenoy's emphasis on agriculture rested on quite subtle and distinct type of reasoning. His idea of appropriate pattern of resource

allocation was based on the twin principles of comparative costs and marginal productivity and was miles away from the usual simplistic "priority" allocations which became the fashion of the times."<sup>2</sup>

In his famous "Note of Dissent" referred to by me earlier, Shenoy argued strongly against price support policy for agricultural produce.

*"Price support of agriculture produce in India is a risky venture and we should be forewarned of the inherent dangers of it... A policy of price support is, in essence, a subsidy... The strain of the subsidy will manifest itself in a shortage of budget resources for the open market purchase and storage of agriculture produce. This, in due course would lead to either abandonment of the price support policy or inflation. In either case damage would result."*

Shenoy recommended the abandonment of procurement of foodgrains by the State. He held that the entry of the State into the foodgrains market as a buyer, stiffens prices and that farmers have demonstrated their high sensitivity to prices and profits.

The Consortium of Indian Farmers Associations questions why most aspects of agriculture such as prices, exports, processing, storage and transportation remain under controls. It says:

*"The Indian farmer has been made a bonded labour to provide low-priced food and low-cost raw material... pushing them towards committing suicides."*

In this context, one may recall the recent banning, in Andhra Pradesh, of lending to farmers by certain Micro Finance

Institutions. This is akin to what Professor Shenoy has referred to as actions designed to protect the farmer against usury but result in obstructing the flow of savings and credit into agriculture and cripple the credit worthiness of farmers. According to Shenoy, actions against usury add to the risk and reduce the profitability of the business of agricultural credit.

Having observed the relevance of Shenoy's writings on inflation, deficit financing, import policy, the foreign exchange crisis, the gold problem etc., one can only hope that in the context of the crisis on the agriculture front, the concerned authorities would pay heed to Shenoy's writings on the abandonment of procurement pricing and removal of all controls.

It is recognised that it is easier to undertake reforms when the whole country is in the throes of a crisis as happened in 1991. To undertake sweeping reforms on the agricultural front, as recommended by Shenoy, when the economy is on a "roll" and only agriculture is in a crisis may be difficult, to say the least. Nevertheless, it may help to recall the role of the Chiapas (Mexican farmers) in the Mexican crisis that occurred in the 1980s.

In concluding let me recall the words of Nobel Laureate, Milton Friedman:<sup>3</sup>

*"Prof. B.R. Shenoy was a great man who had the economic understanding to recognise the defects of current planning in India and what was even rarer, the courage to state his views openly and without equivocation. Rarely does such a man bless our society."*

Shenoy attained international recognition but in India, he faced hostility of opposition from every corner, be it the

Government, the bureaucracy or his fellow economists. .It is a tribute to his foresight and courage of conviction that today his views stand vindicated, in the sense that the liberalisation policy now adopted bear the ideas which he ardently espoused. But, as Professor Parth Shah of the Centre for Civil Society, New Delhi says, "even in these heady days of liberalization men like Professor Shenoy are at the very fringe of public memory."

In many ways, Prof. Shenoy was the Indian Hayek. Like Hayek, Shenoy was hounded out of the corridors where economic counsel was sought. Yet, like Hayek, Shenoy came out of his corner fighting for the causes which were dear to him. While Hayek had the good fortune to be belatedly recognized and honoured by his detractors, it is poetic justice that Hayek was awarded the Nobel Prize jointly with Gunnar Myrdal, both of whom had very divergent views. Unfortunately, Shenoy neither lived to see the turnaround in policies after 1991 nor did he get any recognition. If there was any economist of the post independence period who saw **India's Tomorrow** it was Shenoy. There is a need to recognise the invaluable contributions made by Professor B.R. Shenoy.

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*The views expressed in the booklet are not necessarily those of the Forum of Free Enterprise*

*"People must come to accept private enterprise not as a necessary evil, but as an affirmative good":*

**- Eugene Black**

# FORUM

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