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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

India: Some Economic Consequences of the War

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
March 1972

INTELLIGENCE MEMORANDUM

INDIA: SOME ECONOMIC CONSEQUENCES OF THE WAR

Summary

1. The war has not significantly altered New Delhi's short-term economic prospects. Foodgrain production, which has increased rapidly since 1966 and will hit record highs again this year, was not affected. Industrial production already was in the doldrums when the war started, principally because of government investment policies, raw material shortages, and labor and management problems, and prospects have not worsened. Increased military expenditures of $165 million -- up about 15% -- were financed largely from new government revenues. About 9 million of the estimated 10 million refugees in India have returned to Bangladesh, sharply reducing refugee costs. Moreover, the war has enhanced New Delhi's future export prospects by perhaps 5%, or $100 million, annually by allowing for substantial sales to Bangladesh, although most shipments will have to be aid-financed by India for awhile. New Delhi already has authorized about $176 million of economic aid to Bangladesh.

2. In addition, the impact of the US aid suspension has not yet been felt and could be delayed for a year or so because New Delhi's highly favorable international liquidity position was not substantially altered by the war. Foreign exchange reserves are currently about $1 billion -- the equivalent of about six months' imports -- and substantial commodity aid remains in the pipeline. Moreover, other aid donors are continuing to provide economic aid, and for fiscal year (FY) 1971* new aid of almost $600 million has been authorized. Nevertheless, a continued suspension of US aid will deprive India of a major source of commodity financing that the country

* Beginning 1 April of the stated year.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

needs to support agricultural and industrial production. Over the past several years, US aid has provided about one-sixth of New Delhi's commodity imports, including such critical items as fertilizers, nonferrous metals, and special steels.

Discussion

India's Economy on the Eve of the War

3. Primarily as a result of record foodgrain crops since 1966, India's economy was relatively buoyant before the war – although not without problems. National income growth during FYs 1969 and 1970 averaged about 5% annually, compared with an average of 3% during FYs 1961-68. Exports, which had virtually stagnated throughout the 1950s and early 1960s, increased moderately in FYs 1969-70, reflecting New Delhi's liberalized export policies. At the same time, imports were deliberately held well below earlier levels to conserve foreign exchange, and the trade deficit declined to only about $120 million in FY 1970, compared with deficits exceeding $1 billion in the mid-1960s* (see Figure 1). By December 1971, foreign exchange reserves had increased to $1 billion – the equivalent of about six months' imports.

4. A counterpart of low imports and reduced trade deficits, however, was sluggish industrial and investment performance. The industrial growth rate declined from 7% in 1969 to 5% in 1970 and to only 2% during January-September 1971. Raw material shortages and, in some areas, increasing labor unrest caused some plants to close and others to produce far below capacity. At the same time, investment expenditures were declining.

5. The massive influx of refugees from East Pakistan – reportedly numbering 10 million by November – had placed a strain on India's finances. On the eve of the war with Pakistan, New Delhi claimed that the $300 million from its own funds spent caring for the refugees – about 4% of planned central government expenditures in FY 1971 – had forced cuts in expenditures on other programs. Moreover, the sum was rising by about $50 million monthly. At that time, less than half of the $250 million in refugee aid pledged by foreign donors had been delivered.

6. India's military expenditures had been increasing only at a relatively moderate pace before the war. Spending grew at an average annual

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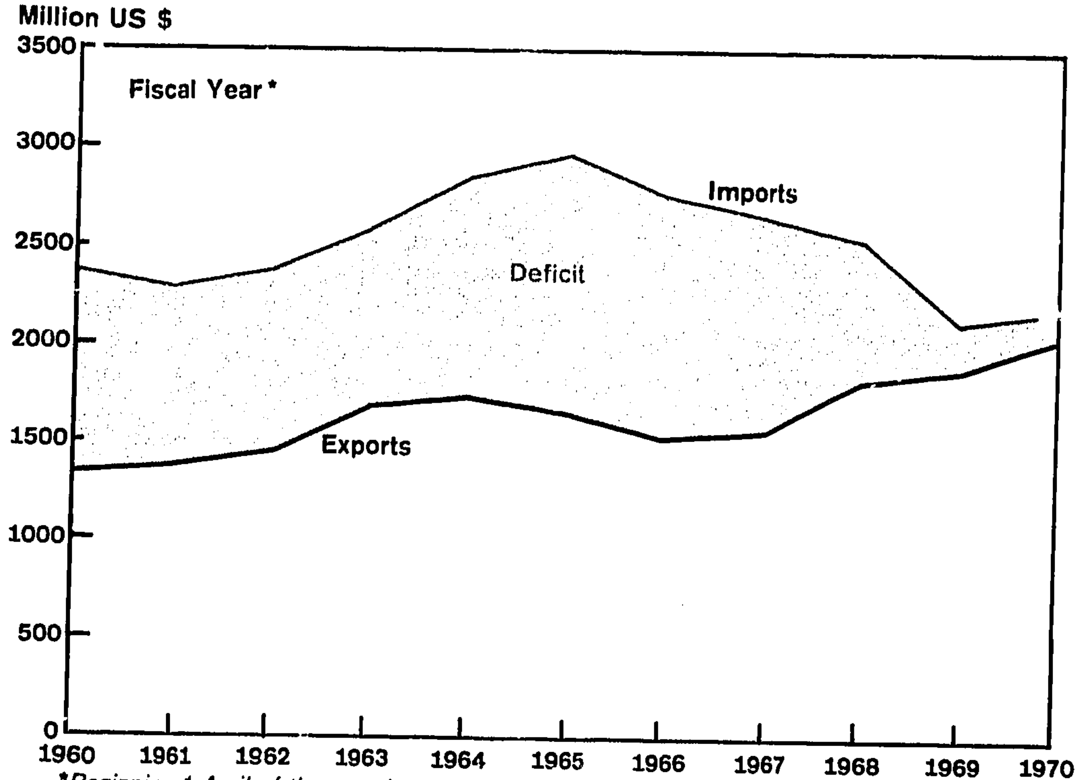
India: Foreign Trade Figure 1



*Beginning 1 April of the stated year.

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rate of about 7% during FYs 1968-70, somewhat more rapidly than national income, and was budgeted to increase an additional 5% in FY 1971, to $1.7 billion. The prewar confrontation with Pakistan during April-November 1971 did not substantially increase military expenditures. Only small additional costs were incurred in transporting troops and providing temporary quarters, and other housekeeping expenses were held down as the armed forces were increased by only about 5% in November. The foreign exchange cost from additional arms deliveries -- mainly from the USSR, Czechoslovakia, and Poland – were financed by credits, aside from small downpayments.

Immediate Costs of the War

7. Hostilities with Pakistan began on 3 December and halted on 17 December, following a cease-fire agreement. Indian economic activity

generally continued without disruption during the war; indeed, industry's chronic labor disorders virtually ceased as the war temporarily unified labor and management. Emergency rationing and price control measures were introduced but no shortages developed, principally because of the war's brief duration.

8. Indian officials estimate total war-related costs at 2 billion to 3 billion rupees ($265 million to $400 million), including additional costs of military operations during the confrontation and the hostilities, the value of equipment lost, and eventual compensation for damage in affected border areas. Military hardware losses alone may total $150 million. The USSR probably will replace much of the more sophisticated equipment lost – such as planes, missiles, and tanks – through long-term credits repayable in rupees. The domestic armaments industry can replace all of the small arms and some of the heavy weapons and ammunition losses.

9. In an action related to the war, the United States suspended $88 million (about 40%) of unused aid that had been previously committed to New Delhi. The $132 million of US aid still in the pipeline was already covered by irreversible letters of credit and could not legally be suspended. Commodity aid accounts for almost all US aid still in the pipeline, as shown in the following tabulation:

	Million US $		
	Project Aid	Commodity Aid	Total
Aid available before suspension	11	209	220
Suspended aid	3	85	88
Remainder available	*8*	*124*	*132*

Aside from a temporary suspension by Japan, which was rescinded after the war, India's other donors did not withhold economic aid.

Impact of War on Economic Prospects

10. The war has not altered New Delhi's short-term economic prospects significantly. Military expenditures have increased sharply, but refugee costs are diminishing, and New Delhi has enacted new revenue measures to offset most war-related expenditures. Only a very small share

of aid to Bangladesh involves hard currency loans; most of the aid consists of food grants and rupee loans to purchase Indian commodities. The US partial aid suspension has had little impact on India's economy because of the aid still in the pipeline.

11. We estimate that military expenditures for FY 1971 increased by about 15%, compared with the budgeted increase of 5%. The anticipated additional expenditures of about 1.2 billion rupees, or $165 million, reflect extra imports of equipment and the added salaries and other expenses generated by the war. Further sharp rises in defense spending in FY 1972 will greatly depend on the magnitude of the expansion in indigenous defense production and the level of foreign arms procurement. Aside from these contingencies, however, a further rise in military spending of only 2% to 3% is expected. War-related replacement costs for arms in FY 1972 are estimated at $85 million, but total military spending will increase little if there is a cutback in the armed forces, as seems likely. A similar leveling off occurred in 1966 following the sharp increase generated by the 1965 war with Pakistan (see Table 1).

Table 1

India: Military Expenditures

Fiscal Year	Million Rupees
1964	8,058
1965	8,848
1966	9,086
1967	9,684
1968	10,332
1969	11,009
1970	11,828
1971 budget	12,417
1971 projected	13,657
1972 projected	14,000

12. By late February 1972, New Delhi had authorized about $176 million for economic aid to Bangladesh, including $32 million for food and cash payments to returning refugees. Soon after the war, New Delhi granted Dacca about $34 million to finance purchases of urgently needed commodities from India. Sugar, salt, baby foods, and drugs were provided promptly; petroleum, fertilizer, cotton yarn, cement, steel, motor vehicles, and power generation equipment were to be delivered as soon as transport facilities would allow. New Delhi also loaned Dacca $13 million in hard currency to meet immediate foreign exchange requirements. Other loans to Dacca since the war include $69 million for foodgrains, $14 million for railroad rehabilitation, and $14 million for civil aircraft and ships. Of the total aid, about $70 million was expected to be used by the end of FY 1971, and the remaining $106 million during FY 1972.

13. Indian officials estimate total expenditures on refugees at about $480 million in FY 1971. About $200 million was covered by foreign grants and the remainder by India's own funds. About 9 million of the estimated 10 million refugees in India on the eve of the war had returned to Bangladesh by late February. Spending for refugees probably will be negligible in FY 1972.

14. New Delhi already has issued new defense bonds and imposed new taxes to finance the additional expenditures generated by the war. A defense loan of $133 million was floated in December, and customs duties and other taxes have been increased sufficiently to yield an expected $86 million in FY 1971 and $180 million in FY 1972. The Minister of Finance also announced that improved tax collection procedures would yield a windfall of approximately $200 million in FY 1971. The anticipated new revenues would offset about 85% of the estimated additional war-related expenditures in FY 1971 and 95% in FY 1972, as shown in the following tabulation.

	Million US $	
	FY 1971	FY 1972
Additional expenditures	*515*	*191*
Military	165	85
Refugees	280	Negl.
Bangladesh aid	70	106
Additional revenues	*441*	*180*
Defense loan and other defense receipts	155	--
New taxes	86	180
Improved tax collection	200	--

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Moreover, according to the Minister of Finance, the war-related increase in the budget deficit in FY 1971 also would be partly offset by a reduction in other expenditures.

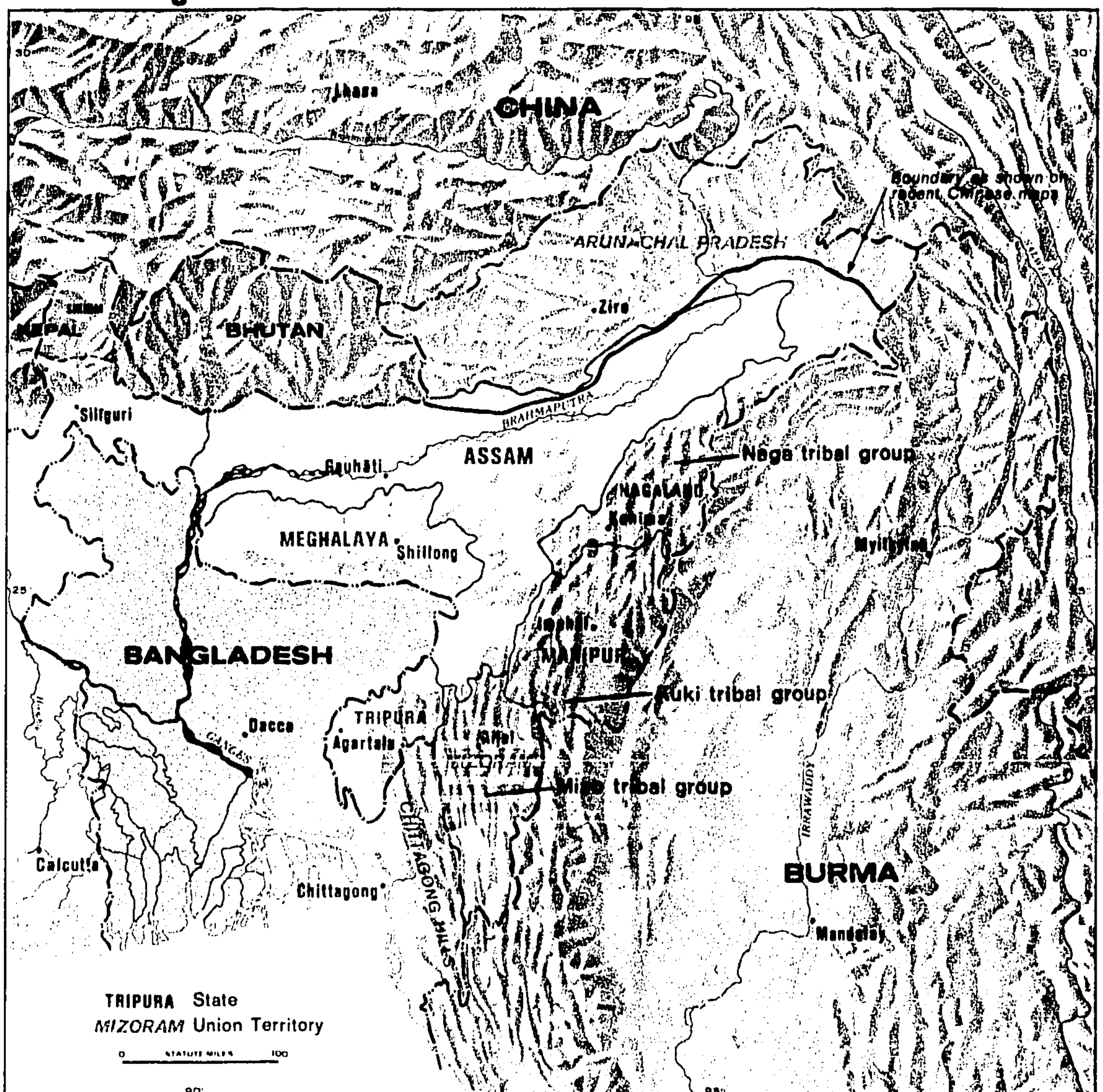
15. India's export prospects are enhanced by the resumption of trade with Bangladesh, which will consist largely of items previously traded between Bangladesh and West Pakistan. Excluding raw cotton, rapeseed, and paper, which are in short supply in India, West Pakistan's exports to Bangladesh averaged roughly $90 million during the past two years. Sales of this magnitude would increase India's export earnings by about 5%. In addition there is scope for trade in other items, although the trade structure will differ greatly from what it was before partition in 1948. Bangladesh then had virtually no manufacturing industry. Exports of jute and tea were shipped through Calcutta, and most manufactures, mainly consumer goods, were purchased from India. Since then, however, demand for investment goods and raw materials in Bangladesh has increased, and the country will probably buy crude steel, coal, and some machinery from India. On the other hand, Bangladesh has developed its own jute manufacturing industry in competition with India, while the latter grew some raw jute. Moreover, the two countries must compete in world tea markets, and both have shortages of rice, vegetable oils, and raw cotton. In any event, the extent of Indo-Bangladesh trade over the next year will depend heavily on Indian economic aid, principally food shipments to Bangladesh. For FY 1972, India's exports to Bangladesh probably will amount to more than $100 million, mostly financed by commodity aid already authorized but not delivered during FY 1971. Some further Indian aid authorizations are likely, but may be small because Bangladesh stands an excellent chance of receiving economic aid from other nations as well.

16. Reestablishing trade routes through Bangladesh into India offers the incidental benefit of improving development prospects for northeastern India (see Figure 2). The region produces more than half of India's tea and one-fifth of its jute and contains one-third of the nation's hydroelectric power potential, half of its petroleum reserves, and two-thirds of its natural gas reserves. Transport costs between the region and Calcutta, its usual link with the rest of India and the world, will be reduced by as much as half. Rail lines previously severed at the border are already being reconnected. Moreover, reduced insurrection by tribal groups previously supported by the West Pakistanis has enhanced the region's political stability. Recognizing the region's changed potential, New Delhi in January 1972 upgraded three previous territories – Meghalaya, Tripura, and Manipur – into states and established two Union Territories – Mizoram and Arunachal Pradesh.

17. Additional foreign exchange payments generated by the war were insignificant, and New Delhi still has a relatively strong international

India: Reorganization in the Northeast

Figure 2



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financial position. Annual payments for military imports – approximately $300 million in recent years – probably have been raised by only about $20 million-$25 million. The hard-currency loan to Bangladesh of $13 million raises the total to roughly $35 million. Even this relatively small foreign exchange drain has been offset in part by refugee aid receipts of about $15 million in hard currency from Western donors because New Delhi in general has supplied refugee requirements from domestic production.

18. The suspension of US aid to date has had relatively little impact on India's economy because of the substantial aid pipeline, some of which remains unutilized. Moreover, India's favorable international financial position will enable New Delhi to weather a continued aid suspension for the next year or two. Although over the past several years US commodity aid shipments – principally fertilizers, non-ferrous metals, and special steels – have provided about one-sixth of India's imports of raw materials, semi-manufactures, and spare parts, New Delhi has alternative sources of financing for these critical requirements. Foreign aid authorizations from other donors are continuing (new aid of about $600 million has been authorized in FY 1971), pipeline commodity aid of about $400 million is available for use, and foreign exchange reserves are about $1 billion.

19. In response to the partial US aid suspension, Prime Minister Gandhi has placed increasing emphasis on India's need to depend less on foreign aid. This dependence has been declining for several years. New Delhi's total net aid receipts had fallen from a peak of $1.4 billion in FY 1965 to about $450 million in FY 1970 (see Table 2). Debt service payments increased while gross aid receipts declined, especially concessionary food imports under PL 480. Moreover, the US share of India's economic aid receipts declined from about two-thirds in the early 1960s to less than half in FY 1970. Despite Mrs. Gandhi's almost daily criticism of the United States, indications are that New Delhi would welcome a resumption of US non-food economic aid.

20. In spite of its favorable foreign exchange position New Delhi has been taking no chances. Indian economic and financial policy continues to be highly conservative. Apparently in reaction to reduced aid levels and the partial aid suspension, New Delhi has imposed additional restrictions on imports to conserve foreign exchange. The Ministry of Industrial Development has initiated a study aimed at identifying indigenous substitutes for a broad range of imports currently imported from hard currency countries. The USSR and East European countries, which conduct their trade with India in rupees, are also being studied as possible alternative trade sources.

Table 2

India: Economic Aid

Million US $

Fiscal Year	Receipts: Total	Receipts: PL 480	Receipts: Other	Debt Payments	Net Aid
1961	714	185	529	214	500
1962	922	258	664	186	736
1963	1,241	389	852	224	1,017
1964	1,536	458	1,078	254	1,282
1965	1,637	503	1,134	263	1,374
1966	1,509	480	1,029	318	1,191
1967	1,594	456	1,138	444	1,150
1968	1,203	210	993	500	703
1969	1,155	226	929	550	605
1970	1,035	210	825	580	455

21. In the aftermath of the military victory, Mrs. Gandhi is in an excellent political position to take strong measures to accelerate economic growth in the short run. She is expected to lead her party to victory in the state elections in March, thus reinforcing her power and influence. She could raise more revenues to support development, for example, by taxing agricultural incomes, currently a function of individual states. It is doubtful that accelerated growth can be achieved, however, because of the shortages of imported materials, which may worsen as a result of the restrictive measures recently introduced.