



IMPLICATIONS OF FINANCIAL LIBERALIZATION IN INDIA

by Francis A. Menezes

Since its financial crisis in 1991, India has slowly traveled down the path of economic liberalization and structural adjustment. Though India has followed these programs, what has been the impact on the nation? Will economic liberalization bring economic equity, prosperity, and growth for all? Or will it lead India down the path towards Armageddon?

With the recent financial crisis radiating from South East and East Asia, one continually hears economists and financial leaders pressing these countries toward liberalization of their economies, under the dictation of the International Monetary Fund (IMF). Yet, in the drive for such austere programs, the people - those most affected and bearing the greatest burden - are forgotten. The notion of economic liberalization is heavily skewed not only in its origins, but in its practice. The greatest proponent of this liberalization is the IMF. Though the IMF is supposed to represent the global community, for all practical purposes, the IMF takes its "marching orders" from the U.S. Department of Treasury and other Western finance ministries.¹

Though India sought IMF assistance in 1991, it was not the first time that they sought aid from an international financial institution. After the second oil shock of 1978-79, with its economy (industrial sector) severely affected, India went to the IMF in 1980-81, requesting credit. It was at that time that India began the slow crawl from the "license raj." This first IMF loan resulted in the introduction of selective economic liberalization, first under Prime Minister Indira Gandhi, and then her son Rajiv.² When India went before the IMF for a second loan, the country owed \$70 billion, with foreign currency reserves drawn down to two weeks.³

Several factors led up to the 1991 crisis. The first was the second Gulf War between Iraq and the U.S. (August 1990 - March 1991), which led to a short-term increase in the price of oil. The second factor was political instability, with no major party able to win a clear mandate from the electorate. Finally, numerous international lenders feared that India would fall into a debt crisis.⁴ Despite these international factors, India conceded to the dictates of the IMF. Jeffrey E. Garten posits that the world was astounded when Prime Minister P.V. Narashima Rao's government undertook measures that opened India's economy in the early 1990s.⁵

There were three major elements of the IMF-dictated conditions India had to follow. First, India had to deregulate and liberalize all markets. Second, there had to be increased competitiveness in

all spheres of economic activity. Thirdly, the government would have to learn to live within its means of a strong budget constraint (fiscal austerity). All aspects of licenses and control would have to be given up. The market that had proved to be the “most prone to imperfection” was that of the financial markets. The reasoning behind this decision resulted from the belief that the government’s tampering in market forces led to the financial market’s inability to clear.⁶

The two fundamental goals of India’s adjustment policy were to enter the global economy, through the “exploitation of benefits that accrue from economic independence,” and to win political maneuvering room.⁷ Though the government was supposed to “get out of the economy,” and pursue more *laissez-faire* economic policies, there still existed institutional requirements for the smooth running of the economy. The predominant requirement was that the government, in a free market economy, provide regulatory institutions that implement policies with regards to competition, while protecting “people from negative, predatory externalities.”⁸ Import liberalization was undertaken with the expectation that it would promote more efficient export production, leading to improved export earning potential which would reduce the current account deficit (closing the gap between imports and exports) alleviating the payment crisis that had obligated India to seek IMF assistance.⁹

Governmental expenditures were the first to be assaulted under the IMF stabilization package. Governmental expenditures declined as a proportion of gross domestic product (GDP) from 11 percent during the 1986-91 period to 10.1 percent during the 1992-95 period. As a result of this, social programs became the first casualty of stabilization. The actual expenditure on rural development and social services declined by 0.4 percent of GDP between 1990-91 and 1992-93. Though the economy picked up after the IMF “programs” were implemented, the amount of public investment declined.¹⁰ One rationale for the decline in social entitlement programs and subsidies was that they were mis-representative, and heavily distorted.

The greatest distortion has been that although the social programs were intended to assist the most needy in society, the programs ended up assisting the better off.

Many of the benefits meant for the poor, like credit and subsidized medicines, have been correctly cornered by the relatively better off people. [This has been done by] directly acquiring these provisions for their own use or by charging a higher price than the one fixed by the government, while selling these benefits to the poor.¹¹

All this was done under the pretense of helping the poor. Furthermore, the national food subsidies were targeted at the urban poor, though the clear majority of the poor lived in the rural areas.¹² Programs were also initiated to assist the rural agricultural poor. The primary method sought was to provide subsidies for fertilizers. What proved ironic, once again, was that these subsidies accrued to the fertilizer manufacturers since the poorest of the farmers used “homemade fertilizers,” such as cow dung.¹³ By fiscal year 1991, the fertilizer subsidy had become quite burdensome, accounting for 1 percent of the GDP during the 1990-91 fiscal year.¹⁴ According to economic gurus, the worst culprit of all has been India’s gargantuan public sector. Following the dictates of the IMF and World Bank, India set about decreasing government expenditures. Namely, the huge, inefficient, and corrupt public sector enterprises fell to the impersonal sword of stabilization.

The public sector in India accounts for as much as 55 percent of the economy's capital stock and accounted for one fourth of the non-agricultural GDP.¹⁵ The privatization of these large enterprises is foremost on the agenda within the structural reform packages. Anand Gupta stipulates that though the "reforms technically and politically are difficult to implement, the economic performance of the country improves when the full reform package is put in place, but the necessary steps are numerous and difficult to coordinate. Furthermore, the entire programs have seldom been enacted."¹⁶ There are problems that are associated with the lack of progress which have dire consequences. The worst, according to Garten, is that with India's paralysis, especially the political polarization within the ruling elites, India will continue to fall behind its Asian rivals, especially South East and East Asia.¹⁷

Anne Krueger states that along with India's welfare loss associated with the controlled economy that limited imports, the lobbying that is involved to obtain these licenses has created a rent seeking system where people have little incentive to effectively reform the system. The amount of resources and manpower diverted into lobbying prevents scarce investment resources from going into more productive activities. Rent-seeking distorts the proper market allocation of resources, creating an inefficient economy.¹⁸

Furthering the economic argument, Marshall M. Bouton explains that India's problem is not politics, rather it stems from economic factors. Though India's reforms have stalled, with the 1997-98 fiscal year, the GDP was forecast to increase by 4 percent, in spite of initial estimates. Bouton believes that with slowed economic reform and lower growth rates, not only will there be economic pain, but that India's social and political progress will be endangered.¹⁹ The greatest threat, as Bouton perceives it, to India is rampant corruption. The previous institutions under state planning and control provided a habitat ripe for rent seeking that fostered corruption. These institutions created all too many opportunities for crooked politicians and bureaucrats.²⁰ Thus, it is all the more imperative that the reforms are carried out.

According to Bouton, there are several reasons why further reform is crucial. First, India's financial sector still cannot effectively mobilize and mediate capital to respond to economic changes. The resulting high cost of capital makes Indian industry and exports less competitive. Second, India's infrastructure is abominable, constraining economic growth. Third, Indian trade has been opened enough to expose many companies to greater competition but not enough to provide a strong, sustained impetus for growth. Fourth, international investors and managers are concerned about the uncertainty of India's macroeconomic policies. Next, India needs greater labor market flexibility to make its companies more competitive and its economy more productive. Finally, foreign investment needs to be dramatically increased, though this has increased over time.²¹ The arguments for economic liberalization appear valid, at least on the surface of things.

Western perceptions, especially those of the IMF, World Bank and the financial ministries of Western Europe and North America are that liberalization will lead to economic prosperity, which in turn will lead to democratization. Thus, the world will become more like the Western liberal democracies. Bouton acknowledges that India's being a democratic nation has proven to be the ultimate source of state legitimacy.²² Until the recent phase of contemporary financial crises that

rocked the developing world since the debt crisis of the early 1980s, the newly industrialized countries (NICs) of South East and East Asia had been touted as the role models of other developing nations. What has been glossed over in the advocacy of following the “economic development paradigm,” approved by the Asian Tigers, is the lack of and disregard for human rights. The U.S. and its allies, who have not only promoted but also ignored the violation of human rights in these regions, “sponsored” these countries.²³ Hence the elites in India have taken to heart the differing aspects of the NICs development, and have chosen to liberalize India’s economy with caution – resisting U.S. pressures for a fast track approach that would allow unfettered access to the Indian economy.²⁴

Why has India chosen to take a more gradualist approach? More importantly, what have the implemented economic reforms to date meant to the people of India, not just the wealthy or middle class, but the rural poor? The above discussion of what the economic reforms entailed and some benefits at the macro level fail to fully describe what economic liberalization is, and what its effects are. For many economists, and financiers, economic liberalization is the culmination of all the hopes, dreams, and prescriptions advocated by Adam Smith. Many of these people forget that Smith recognized the necessity of having government involvement in society. Though he advocated the allowance of the market to work, he advocated government’s responsibility in ensuring that public goods were not mindlessly wasted, as well as recognizing the necessity of protecting certain key industries for national defense as well as for the establishment of infant industries.²⁵ Thus, import substitution industrialization (ISI), became the protection mechanism of infant industries until they matured. The problem that arose with ISI was that there existed strong possibilities. In fact this has been born out in practice throughout most of the developing world where backlashes would foster rent seeking and bureaucratic corruption.²⁶

With the repudiation of ISI after its practice in Less Developed Countries (LDCs) for the past 30 plus years, economic liberalization, under the coercion of the IMF and others, was instituted. Yet, India chose to liberalize in a cautious, and deliberate manner, judging at what pace the country would tolerate liberalization. Furthermore, the shock therapy implemented in Poland with a crash program that made a swift conversion from a planned economy to a liberal economic system, was rejected as a possibility because it could potentially create too many losers in the short-run with clear winners emerging in the medium to long term.²⁷

The institutions that now exist in the free market economies of developed countries have evolved over time. Furthermore, the shock therapy implemented in Poland and the reforms undertaken in other former communist countries of Eastern Europe and the former Soviet Union illustrate the severity of the situation of moving towards a fully market-oriented economy too quickly. What is apparent, but often overlooked, is the lack of developed institutions in the countries that followed the state controlled directed economies. Time becomes a crucial element in the evolution of institutions, and they can not be engineered at will.²⁸ Yet, these developing countries do not have the room to develop institutions that would monitor the economic situation, as well as regulate the economy – ensuring that there are protections from the market’s negative effects.²⁹ Along with these types of regulations, institutions need to be established in order to safeguard people from market failures equivalent to the savings and loans crisis that occurred in the U.S. during the 1980s.

With the government's provisions to protect against the negative side effects of the market, there also needs to be transparency regarding information within government agencies in order to purge the information gap.³⁰ The need for transparency has been highlighted in light of the financial crisis. One of the primary elements that have exacerbated the crisis is the lack of transparency within the financial systems in South East and East Asia. Due to the close relationship between the governments and business sectors in these countries, there has been a lot of asymmetric information exchanged between the governments and companies on the one side, and the international financial community on the other. Transparency, in other words, creates confidence, while secrecy perpetuates and exacerbates fear. Increased access to information regarding the running of banks and financial institutions within a country to investors, depositors and borrowers increases confidence.³¹ Among the countries that were directly affected by the financial crisis, the international investors and depositors first saw Thailand devalue. After realizing the neighboring countries were in a similar situation, investors pulled their money out. This simplification of a complex, real-world event illustrates the need to have institutions in place so as to deal with external, international forces that liberalization opens a country to the global economy.

Though only partially through her program of economic liberalization, fortunate for India, the deficit identified by Jeffrey Garten as being India's "political instability," turned out to be an asset. If India had had a "stable government," international investors pulling their capital out of the "Asian Tigers" would have drowned India. Without an adequately institutionalized financial system, India would have gone the way of South East and East Asia.³² As Andrew Freris, the managing director at Bank of America Research in Hong Kong pointed out, "India is one of the least trade-dependent economies. Its economic cycle is entirely driven by domestic factors." Furthermore, India's total exports amount to approximately 10 percent of GDP.³³ Although the gradualist approach as well as India's perceived political instability prevented what might have been to a repeat of South East-East Asia, the explanation for why India should gradually "liberalize" is precisely the lack of broad based, fully developed market and financial institutions.

Even these explanations do not fully explain why India should take a gradual approach to "economic liberalization." Rather, they indicate what needs to be done before, or during the process laid out by the IMF, World Bank and Western pedagogues. Who benefits? At times it is not always evident who the winners and losers are in a program such as this. However, if one were to travel within India, or South Asia it would be clear that there is a growing income gap across the region. In fact, the opening up of India has led to what some have called a re-colonization of India, with key industries and consumer factories being bought up.

The question, "Who benefits?" is an essential question, intrinsically intertwined with the questions: "Who is marginalized?" and "Who are the victims of this strategy?" One of the most visible beneficiaries of economic liberalization is the transnational corporations (TNCs).³⁴ Thus, one sees the "return from exile" of TNCs that formerly prospered in India. One such company, Coca-Cola, proceeded to buy out the top three popular soft drink brands. Although it is ranked third among Indians.³⁵ What were the reasons for this? One explanation has been that since TNCs have immense international capital reserves, they are able to undercut local operations (or dump their products). TNCs are able to repatriate profits back to their nation of origin, which reduces the re-investments in the local economies in which they operate.³⁶ Another example is the case of the Enron energy project in the Indian State of Maharashtra. Members of the state government of

Maharashtra alleged that Enron had paid out bribes in order to get the contract to build power generators, and then sell the energy to the state governments. Former U.S. Ambassador Frank Wisner's warning to the Indian government that if the deal with Enron was not "settled in an appropriate manner," Indo-U.S. newly established business ties would suffer may have buttressed Enron's success.³⁷ Now, with Wisner retired from U.S. government service and sitting on Enron's board, Enron is looking to lead a \$20 billion, three year, and energy development plan for India. Further, Enron does not believe that having an Indian partner would have mattered with its dealings with the Indian and Maharashtra government, and does not seem inclined to seek cooperation or collaboration with Indian firms.³⁸ TNCs do not always abhor working in collaboration with Indian firms. One only has to see the lengthy relationship that has existed between Japan's Suzuki and India's Maruti auto manufacturer since the early 1980s. Often, with the opening of the economy, the ones who suffer the most are the workers, not just the urban factory workers, but the rural agricultural poor.

Because industrialists have access to credit at better terms both at home and abroad, TNCs use modern technology to replace the local technology already in use in production.³⁹ Small-scale industries become one of the numerous casualties of this Anew policy since formerly protected markets are now open to outside competitors. Furthermore, since the industrial labor force is a captive supplier of a resource (labor) they become price takers. In essence, the middle class, estimated at approximately 150 million people, captures benefits from liberalization.⁴⁰ While the middle class is expanding, so to are the numbers of people in poverty.

One of the programs that is almost automatically curbed is a social program for not only the poor, especially the urban poor bias, but the programs that assist specifically the rural poor.⁴¹ The poverty and welfare alleviation programs rely heavily, though not solely, on many of the government's social services and human development programs.⁴² Among the worst hit are women, their employment and status. Seventy-six percent of women workers are employed in the agricultural sector. Further, the majority of women are subject to the slightest shift in productivity, especially when it results from the economic reforms that are implemented from above.⁴³ Therefore, liberalization reinforces the existing trends of exploitation of women. For they are amongst the first to be laid off when times get hard for factories and small industries. Often because of displacement from their homes, or from deforestation woods and forests near their homes, rurally based women (along with tribals) find that they are compelled to spend significant portions of their daylight time searching for fuel, food, and water.⁴⁴

Thus, any program that is meant to aid the nation economically must address the needs of the millions of poor in the country. S. P. Gupta addresses this problem best when he asserts that any reform policy, even at the stabilization phase which is not friendly to the agricultural sector has grave implications. Reforms require a reduction of subsidies and appropriate price corrections. Not only do the poor suffer from decreased investment in agricultural investments, but also they are doubly hit when the government reduces health care expenditures.⁴⁵ A prime example of not only corruption, but of how far the effects of economic liberalization have impacted the lives of villagers in rural India are the recent mass suicides, such as in the case of Bundelkhand in Southern Uttar Pradesh.⁴⁶

Suicide has been aggravated by the economic and austerity reforms India has undertaken. The

plight of those in the depths of misery in India is such that poverty is often the noose around the people's neck, with the lack of government action the tightening, stretching of the rope. Starvation is stalking Bundelkhand, poverty is on a permanent visit, and an entire people have found that there is only one escape from hunger suicide.⁴⁷ The reduction in government investment in the agriculturally depressed areas has meant that there is little, if any, investment going into ensuring an adequate supply of water and agricultural supplements for farming. There is no industrial growth in these areas, with jobs becoming more and more illusionary in an area already experiencing rural migration at a rate of nearly 40 percent, compared to a national average of 11 percent. The talons of poverty spare none.⁴⁸ As a result of international competition, small-scale industries have been closing not only in Bundelkhand, but also throughout India.⁴⁹ The cottage industry of (red) stone statues, wooden furniture and toys has also collapsed with the entry of multinational companies in the market.⁵⁰ It becomes apparent that the government of India, as well as the Indian middle class and TNCs, has become completely enthralled with the economic liberalization, as have the IMF and the World Bank.

I.G. Patel posits that "to allow foreign investment freely in areas where there are no strong domestic competitors and where there is little possibility of exports or of liberal imports is to hand over lucrative and protected domestic market to foreign investors."⁵¹ Adam Smith, the guru of liberal and neo-liberal economists, correctly advocated the protection of infant industries, as well as enticing them to become both productive and efficient. Along with opening up of protected markets to international competition, as previously mentioned, economic liberalization calls for the reduction in government expenditures.

Government expenditures can be reduced only to a certain point, after which it is unable to go below a specific level. The reduction of deficits is a *sin qua non* of reforms. But if that has to be done without raising the tax rates, public expenditures have to be brought down. Ultimately, a national government reaches a point whereby, if it were to reduce expenditures below a certain level, the long-term consequences for the country would potentially affect the government's ability to function and provide inadequate investment in desired and necessary social and infrastructure programs.⁵² The short-term externally and internally mandated reduced expenditures in social programs have the potential for fostering conditions placing India at a strategic and economic disadvantage vis-à-vis current and potential economic trading partners and rivals.

By 2020, India is expected to rank fourth economically in the world based on purchasing power parity, after China, the U.S. and Japan. With one-third of the land as compared to mainland China, India is expected by 2040 to surpass China in population and snatch the dubious title of being the most populous nation in the world. Furthermore, even though the current population growth rate is 2-2.1 percent, and expected to drop to 1.5 percent after the millenium, there are many who fear that Thomas Malthus' prediction of population growth will come true in the developing world, particularly in India.⁵³ Malthus argued that because land is finite and its productivity increased arithmetically and population grew geometrically, an increase in population would outstrip the availability of food supply, condemning people to live in misery and poverty. Though he was writing with regards to conditions prevalent in nineteenth century Europe, these predictions have been applied to the LDCs of today.⁵⁴ Another problem with economic liberalization within LDCs is debt repayments.

In terms of hard cash, for instance, the debt-related transfers of resources from 1984 turned out to be from the South to the North, the net amount being as high as \$163 billion between 1984 and 1988. Furthermore, the overall net credits from the IMF to LDCs have proven to be negative, with the Third World under the thumb of the Industrial North.⁵⁵ This is clearly illustrated in how the General Agreement on Trade and Tariffs (GATT) reflect the desires of Western, Northern Industrial powers. The majority of trade that takes place is between the developed nations.

Furthermore, the adamant advocacy for privatization, deregulation, devaluation, and a free rein to TNCs reflects the skewed nature of the agreement. In addition, market access for Northern countries, has proven to be detrimental to poorer sections of society in developing countries. The removal of price controls, especially food, serves to only further aggravate the economic crisis for the poor. One could make the argument that the increase in poverty serves to increase competition among laborers for employment, driving down wages, all to increase profits for TNCs. All that is required is a reduction in social spending, which results in increased food prices, increased transportation costs, and most importantly increased public service fees, which will allow the burgeoning of TNC pocketbooks.⁵⁶

The poorer sectors of society are condemned to life in squalor and misery, while the economic policy making within the country becomes even more centralized and secretive. In addition, the First World, championed by the U.S., has advocated that the indigenous security and police forces be trained in the West, especially in such notable institutions as the School of the Americas.⁵⁷ Patnaik and Panda have clearly articulate how: "India has followed the dictates of European and North American Colonialists. Foreign capital has been used to rape LDCs of natural resources, and exploit their cheap, yet skilled labour, all in the name of the bottom line."⁵⁸ Along with the rapacious behavior, international financial institutions circling around LDCs have scented, blood profits.

India has fallen prey to the new theocracy spreading its insidious tentacles throughout the developing world. The present debt owed to developed countries has mushroomed, from \$75 billion US at the end of the 1980s to \$90 billion in 1994, soaring to nearly \$99 billion at the beginning of 1996, making India the third most heavily indebted nation in the world.⁵⁹ India's enchantment with economic liberalization has proven to be counter to their national interest. The abandonment of the cherished principle of growth with justice, social responsibility and accountability, equity and self reliance has not only left behind vast numbers of marginalized people, but also created a volatile time-bomb Awaiting to go off. Governmental divorce from Asocial responsibility for the less advantaged has proven to be detrimental to the lower classes of society.⁶⁰

A return to some of the Gandhian-Nehruvian pedagogues is essential for the economic, and especially the political survival of the nation. Although ISI, as implemented in India and other LDCs, proved capable of augmenting the establishment of key industries, this paradigm is incapable of moving past the domestic industrial, infant industry stage.⁶¹ Gandhi believed that India should grow by using India's internal resources, where people, materials and technology were available. This would avoid the migration of the masses, which would lead to the *urbanization* of India, and the associated problems of unemployment, homelessness and crime.

Gandhi believed that it was within the towns and villages that the people in India lived where economic growth should take place. Nehru, on the other hand, believed that this type of program would take too long for India to attain autarky from small-scale industries alone. Rather, he desired to bring India into the modern contemporary world as soon as possible, while still retaining a free society and maintaining a stable political system.⁶² A refusal to recognize these ideals in the formulation of economic policy is tantamount to genocide. For the government of India would be placing economic sanctions against its own people.⁶³

Instead of blindly following the dictates of the “new and improved colonials,” India must chart her own course. Economic liberalization, in its present manifestation, is a contemporary Western response to Rudyard Kipling's *Take Up the White Man's Burden*. This new developmental paradigm has enslaved Southern LDCs to the Industrial North, as well as to the Northern international financial institutions. India has been charged with working towards a medium that maintains the idealism of Nehru, Gandhi and their humanitarian visions – a responsibility to all of its people.

Faith in the elephant is well placed. India has existed for thousands of years, assimilating different philosophies, economic practices, cultures and religions. The medium shall be found. For as Shalendra D. Sharma wrote about Kipling, "As Kipling noted long ago, when the lumbering elephant begins to move at a measured gait, all sensible men and beasts get out of the way. The timers must now contend with the elephant and Kipling always placed his bets on the elephant."⁶⁴

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- ^{54.} Christopher Pass, et al. (1991) "Thomas Malthus." p.309-310 in *The HarperCollins Dictionary of Economics*. New York: HarperCollins Publishers.; Donald Winch. (1997) "Malthus." in *Three Great Economists: Smith, Malthus, Keynes*. Eds. D. D. Raphael, Donald Winch, and Robert Skidelsky. New York: Oxford University Press.
- ^{55.} C. T. Kurien. (1993) "Indian Economic Reforms in the Context of Emerging Global Economy." *Economic and Political Weekly*. April 10. Vol.28, No.15; p.660.
- ^{56.} Jaganath Pathy. (1995) p.13-17; Smitu Kothari. (1997) p.99.
- ^{57.} Smitu Kothari. (1997) p.109, 114.
- ^{58.} Gopabandhu Patnaik and Domadar Panda. (1992) p.210.
- ^{59.} Surendra K. Kaushik. (1997) p.77.
- ^{60.} Jaganath Pathy. (1995) p.11-12, 17.
- ^{61.} Surendra K. Kaushik. (1997) p.73.
- ^{62.} Op Cit. p.71-73, 81.
- ^{63.} Economic sanctions are a form of genocide, for they specifically target people, either a nation, or specific region for example. The victims are incapable of confronting their oppressors, for they have had all voluntary volition abducted by a "higher" more powerful authority, either the state or an outside power, i.e. the U.S. with its entourage maintaining economic sanctions against the people of Iraq for over seven (7) years.; Professor Johan Galtung's course: Conflict Transformation skills workshop at American University, March 27-29 , 1998; Discussion with Galtung on April 11, 1998.
- ^{64.} Shalendra D. Sharma. (1996) p.418.