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India's Economic Liberalization: A Progress Report

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Despite incremental and frustratingly piecemeal implementation, India's economic liberalization project has finally dispelled the specter that had haunted the country for so many years after independence: the stagnant 3 percent "Hindu growth rate." Indeed, with an average annual growth rate hovering above 6 percent, India was one of the world's fastest-growing developing economies in the 1990s.

The driving force behind economic revival is this ambitious reform program put into place after a severe balance of payments crisis in 1991. That year—in the face of a quickly deteriorating fiscal position, increasing external debt (especially short term), accelerating capital flight, and rapid depletion of foreign reserves—the Indian government, on the verge of defaulting on its foreign debt, was forced to seek emergency assistance from the IMF. In return, Prime Minister P. V. Narashima Rao's government promised to enact a wide range of macroeconomic reforms designed to "convert India from . . . [an] inward-looking economy into a market-friendly, outward-looking one."

The reform program that followed broke decisively with more than four decades of pervasive government planning and regulation that had earned India the dubious distinction of being the most controlled economy in the noncommunist world. The reforms have included the abolishment of state monopoly in virtually all sectors of the economy, significant liberalization of industry and trade, deregulation of the financial system, improvements to supervisory and regulatory systems, cuts in tariffs, and the introduction of policies favorable to privatization and foreign direct investment (FDI).

One of the most dramatic changes has been the liberalization of trade policy. Under the highly restrictive pre-1991 trade regime, government authorization was required for the import of virtually all goods; imports of manufactured consumer goods were completely banned. Maximum tariff rates exceeded 300 percent and the average tariff rate in 1990–1991 stood at 87 percent—the highest in the world. By 1994 the average tariff rate had declined to 33 percent and was approximately 20 percent in 2000.

Major change has also come to the industrial sector. Before the reform period, a long (and continually growing) list of industries, including iron and steel, heavy machinery, oil and petroleum, air transport, mining, and telecommunications, was reserved solely for the public sector, under the intrusive eye of the Monopolies and Restrictive Trade Practices Act. In a short period of time this heavily protected industrial sector has witnessed the virtual abolition of the industrial licensing system and other regulatory impediments. (Compulsory licensing is now required mainly for environmental, safety, and strategic reasons.) Moreover, many sectors of the economy previously reserved for state control have been opened for private investment, including power, telecommunications, mining, ports, transport, and banking. Substantial progress has also been made in phasing out remaining quantitative restrictions on agricultural, textile, and industrial products.

Prior to 1991, strict restrictions on FDI had reduced it to a trickle; since 1991 controls on FDI and portfolio investment have been significantly relaxed. Automatic approval of foreign investment of up to 51 percent of shareholding is now permit-

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ted for a wide range of industries (and since 1996 the list of industries in which FDI is permitted has been further widened, with 100 percent foreign equity and ownership permitted in some sectors). In September 1992, portfolio investment was allowed for registered foreign institutional investors, and Indian companies were permitted to raise capital from abroad by issuing equity in the form of global depository receipts and other debt instruments. The reforms in the financial sector have not only forced Indian companies to improve the quality of their products, but have enabled many to restructure their activities through mergers and acquisitions.

Banking has been subject to gradual reform since the early 1990s. Regulation and supervision of the banking system have been strengthened. In the past two years, a series of measures to reduce the number of nonperforming loans (especially in public sector banks) and to restructure three public sector banks has been implemented. The Reserve Bank of India—the country's central bank—has also strengthened prudential requirements, including raising minimum capital and capital adequacy ratios to conform to international standards. Equally important, greater competition in the banking sector and improvements in the capital and debt markets have reduced reliance on central bank financing.

"An idea whose time has come"

Cumulatively, these reforms have reawakened among India's entrepreneurs what John Maynard Keynes once called the "latent animal spirits," thereby giving a sharp boost to growth. Nowhere is this dynamism more evident than in the information technology (IT) industry and the service sector. Ten years ago, India's computer industry had total sales of $150 million. In 2002 its exports were more than $6 billion—or 13 percent of India's total exports. Indeed, India's IT industries now have a proven track record and an international reputation for quality. The city of Hyderabad is known as Cyberabad, and soon Indian companies such as Infosys, Wipro, and Satyam could be household names around the world. India also accounts for a third of the world's software engineers.

Robust exports of food and capital goods, garments, engineering tools, and refined petroleum products have also contributed considerably to India's growth in recent years. But it is the country's rapidly expanding services sector that has provided growth and stability in the post–September 11 period, which has been characterized by uncertainty, financial market turmoil, and a sharp global economic slowdown. Services currently account for 40 percent of India's GDP, 25 percent of its employment, and 30 percent of export earnings.

And what about the balance of payments crisis that drove India to reform? For the sixth consecutive year, India has recorded a surplus, despite increases in oil prices, a sharp downturn in international equity prices, and successive increases in interest rates in the United States and Europe. Foreign exchange reserves have risen steadily from $42.3 billion in March 2001 to a record level of nearly $72.4 billion in January 2003, which is equivalent to almost 14 months of estimated imports for the current year. Reserves are now more than four times the level of short-term external debt, providing India with a substantial buffer. In fact, India's external debt situation has improved significantly in recent years as a result of effective external debt management. The foreign debt–GDP ratio decreased from 28.7 percent at the end of March 1991 to 20.8 percent at the end of March 2002. The debt–service ratio declined from a peak level of 35.3 percent of current receipts in 1990–1991 to 16.3 percent in 2000–2001. For the first time, the World Bank has classified India as a "less-indebted country."

The economic growth catalyzed by the reforms has benefited (albeit unevenly) all sectors of society, so that India can finally point to a positive change in the country's stubborn poverty problem. Reaffirming that the link between economic growth and poverty reduction is unambiguous, the latest official surveys indicate that poverty levels have fallen from about 40 percent of the population to roughly 28 percent during the second half of the 1990s. This translates into a net reduction in rural poverty of some 60 million people between 1993 and 2000. (In rural India, poverty fell to 27 percent of the rural population, while urban poverty fell from 32 percent to 24 percent of the urban population.)

Victor Hugo once noted that "there is one thing stronger than all the armies in the world, and that is an idea whose time has come." The idea of market reforms that swept the world some two decades ago is now part of India's development vocabulary. Although supporting reforms was once considered politically incorrect, every major political party recognizes the need to "deepen" the reforms. The differences in opinion that occasionally arise are about the pace and ordering of reforms. Fears that changes in governments will undo what has been achieved or bring the reform process to a halt are without merit.

FUNDING THE STATE . . .

The accomplishments of the past decade, while impressive, are dwarfed by what remains to be done. Of growing concern is the failure to maintain the economic momentum achieved through the early 1990s. Many had concluded that India's potential growth rate under reform is about 8 percent annually, but recent experience has fallen short of that: growth has shown a decelerating trend since 1997. Prolonged droughts, international sanctions following nuclear testing in 1998, high energy prices, and the devastating earthquake in the state of Gujarat in late January 2001 that killed approximately 20,000 people have all contributed to the slowdown. But the main reasons are egregious domestic macroeconomic distortions, a slackening in the pace of reforms in particular, and half-hearted attempts to follow through with the more difficult, yet crucial second-generation reforms such as financial regulation and labor law modernization.

The heart of the problem is India's peculiar system of fiscal federalism, which makes it impossible to reduce the skyrocketing fiscal deficits of the central and state governments. Specifically, under India's deeply flawed fiscal system, the central government allocates credit to state governments through a "formula" that is unrelated to whether state governments put their funds to productive use. Not surprisingly, state governments, in their eagerness to win elections, often make fiscally irresponsible campaign promises, and then pay for them with funds allocated by New Delhi. Currently the combined federal and states' deficit exceeds 10 percent of GDP—the highest level since 1990. As a result, general government debt has risen to almost 65 percent of GDP. This huge fiscal deficit has placed tremendous upward pressure on interest rates and has also discouraged private investment.

To redress this problem, several state governments have signed memoranda of understanding on fiscal reform programs with New Delhi, and the process of reining in expenditures by reforming food subsidies and prices for petroleum has begun. Attempts continue to reduce the government's stake in state-owned enterprises, which remain a drain on resources. To enhance the revenue base, efforts are under way to improve tax collection.

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. . . AND REFORMING REGULATION

Additional challenges to further reform are India's infrastructure and regulatory bottlenecks. India's roads, railways, telecommunications, electric power, air transport, and ports need expansion as well as improvement in the quality of service. These issues can be best addressed through regulatory reform and increased investments. Although this area has been opened to private investment—including foreign investment—the authorities have been unsuccessful in creating a fully supportive environment for the private sector. For example, as part of the reform program, private investors are expected to generate electric power for sale to state electricity boards, which oversee transmission and distribution. But because of the boards' poor administrative capacity, along with the loss (or theft) of power during transmission and low electricity tariffs for many categories of consumers, private investors have concluded that the boards simply cannot guarantee payment. Indeed, many private investors have yet to be paid, while others are now demanding terms guaranteeing purchase of electricity by both the federal and state governments before they invest. Resolving this problem is critical; no sector of the economy can achieve successful transformation without an adequate and reliable supply of power.

Another critical part of the economy—the agricultural sector, which employs 60 percent of India's population—has also been ill served by the reform process. Declining public investment in irrigation, soil conservation, water and flood management, and rural infrastructure (coupled with only a modest rise in private investment in agriculture) has contributed to the deceleration in agricultural growth in the second half of the 1990s. The decreased public investment in agriculture can be traced to the poor fiscal position of state governments and the maintenance of generous support for inefficient subsidies. For example, as much as 0.7 percent of GDP goes into fertilizer subsidies. The major beneficiaries of this subsidy, however, are the poorly managed domestic fertilizer industry and high-income farmers.

Further exacerbating agricultural problems are outdated laws and regulations. The government's guaranteed price support for food grains—crucial in the 1960s and 1970s to give farmers the incentive to produce more food grains—has outlived its usefulness. Today, price controls are maintained for staples to ensure remunerative prices for farmers. As a result, support prices have been fixed higher than market prices, encouraging overproduction. This has led to an increase in the stock considered necessary to ensure food security (60 million tons in mid-2002, as opposed to a more reasonable 17 million tons).

Although the central and state governments have justified the maintenance of high support prices on the grounds that it allows them to procure and subsidize the sale of certain commodities to low-income families through the public distribution system, these claims are not entirely valid. It is well known that this system does not adequately distribute food to the needy. Yet, procurement by government agencies continues to increase—in large part to maintain the support prices (agriculture is also shielded through import and export controls, including tariffs and export restrictions). The abolition of the price support system is not likely in the near future, but it clearly needs to be better aligned to market demand if farmers are to be encouraged to shift from overproduced food grains like wheat and rice to other staples.

NEXT STEPS

The Indian economy still remains relatively closed—at least by standards of the fast-growing economies of East Asia. Tariff levels are among the highest in the developing world; FDI remains low (FDI in India averages 0.5 percent of GDP; in China it is 5 percent of GDP); and currency restrictions need to be lifted. Domestically, privatization of state-owned businesses must be accelerated, regulation of the financial sector improved, labor laws modernized, and investment in primary education strengthened.

A government planning commission has reported that growth rates of between 8 and 9 percent annually over the next decade are required to reduce India's poverty rate to around 11 percent. The per capita income levels in China and other East Asian countries that were roughly comparable to those in India in the 1960s are now much higher. Renewing the momentum of reform, and thereby broadening and reviving growth, is essential if India is to achieve its economic goal of breaking out of the third world. ■