ECONOMIC REFORMS IN INDIA: A BALANCE SHEET

Narendra Jadhav[1]

Friends,

It is a privilege to be here today at the INTECH Institute of Business Management. I am indeed grateful to the Governing Council for inviting me to deliver the Foundation Day Lecture 2004. I might add that the students of this institute and I are actually *guru bhai*s, in the sense that we share a common teacher, Professor Bharadwaj, who taught me at Bombay University.

The Indian macro-economic landscape has changed dramatically in the 1990s and thereafter. A relatively closed and control-oriented economic regime is giving way to an open market economy. In line with the process of globalisation, the Indian economy is getting increasingly integrated into the world economic order. Many people do not know that the Indian economy, today, is actually more open than the American economy.

This inevitably raises the question, are we any better off? It is now almost twelve years since we have initiated the process of economic reforms in the Indian economy. This now allows us to draw a balance sheet of the successes and disappointments of the structural changes which have taken place in the economy since the early 1990s.

It is to this challenging task of assessing Indian structural reforms on which I would like to focus today. My presentation is divided into three sections. Section I begins with a bit of a background about why reforms were necessary in the first place. Section II draws a balance sheet of successes and disappointments. Section III ponders over the challenges and opportunities of the emerging world economic order.

[1] Principal Adviser and Chief Economist, Department of Economic Analysis and Policy, Reserve Bank of India.

A Primer on Reforms

Why reforms?

As it is well known that India, like most countries in the developing world, followed a path of planned self-reliant development after her Independence in 1947. This was a conscious choice of political economy, expected from a strong nationalist political leadership, which had just won independence from colonial dominance. Besides, the emerging literature in development economics had then stressed the need for large-scale public investment to provide a big push for industrialisation.

With the benefit of hindsight, it is now clear that although the entire development strategy had hinged on public investment as an engine of growth, large fiscal deficits arising from excessive government spending began to sear the macroeconomic balance. India seemed to be caught in a low equilibrium trap of the so-called 3.5 per cent Hindu rate of growth. Although GDP growth did pick up to almost 6.0 per cent levels in the 1980s, this was driven by a massive expansion in the Centre's fiscal deficit. The growing structural imbalances in the economy - the current account deficit climbed over 2 per cent of the GDP by the end of the 1980s – inevitably culminated in a severe balance of payments crisis in July 1991.

The cataclysmic events of 1991 proved to be a watershed in the national economic strategy. The poor Indian macroeconomic performance, especially in relation to the evolution of the South-Asian tigers, had already fostered a degree of revisionism in favour of a greater market orientation of the economy. It was recognised – and also testified by emerging contemporary economic theory - that state failures could be just as costly as market failures and that state intervention, however elaborate and however intellectually refined the planning process might be, was not a panacea for a process of market allocation of resources. It must be appreciated that although the market orientation of

Indian economic reforms was crisis-driven, there was already a groundswell of intellectual support for change.

What did the reforms entail?

The process of economic reforms, initiated in the early 1990s, essentially aimed at harnessing the externalities of competitive efficiency for the process of economic development. This has touched almost every sphere of our national economic life:

- Structural reforms in the real sector aimed at allowing a greater inter-play of a market-driven process of resource allocation and pricing. This involved the dismantling of the industrial licensing *raj*, price controls and an infusion of competition through the introduction of a larger number of players – including foreign companies – even in sectors, which were earlier government monopolies.
- This was supported by a process of financial liberalisation so as to enable the process of price discovery to guide the allocation of resources in the financial markets. Financial repression gave way to financial liberalisation. This, in turn, implied that our financial system had to mature from a mere channel to an active allocator of resources.
- Concomitantly, the Indian economy was opened up through a complementary process of trade liberalisation and financial liberalisation. This, in turn, was calibrated with the process of institutional reforms at home.

A Balance Sheet of Reforms

Let me now turn to a balance sheet of the changes taking place in the macroeconomy during the 1990s. First, the good news: higher and resilient growth, broadbasing of economic development, a change in the national

psyche, which is buttressed by the growing strength in the external sector. I will then turn to the bad news: inadequate employment, large-scale poverty, persistence of fiscal deficits and poor agricultural investment.

Higher and Resilient Growth

The foremost achievement of the process of economic reforms was surely to put the Indian economy on a higher growth trajectory. Real GDP has grown by about 6.0 per cent since the early 1990s, which is, of course, far above the 3.5 per cent GDP growth clocked in the earlier decades. It is true that the 1980s were also able to register a growth rate of a similar order. The critical difference between the 1980s and the 1990s, I would argue, lies in its resilience.

In the past, the Indian economy was vulnerable to a process of domestic and external shocks, such as a drought or a sudden jump in international oil prices. For example, in each of the years, there was a drought (say, the episode of 1965-7 or 1987-88), there was high inflation. Similarly, every time there was a oil shock (say, 1974, 1979 or 1990), the economy landed ourselves in a balance of payments crisis (in 1975, 1982 and 1991).

In contrast, the national economic experience of the 1990s demonstrates that the Indian economy is now increasingly resilient to such shocks, breaking the cycle of going to the International Monetary Fund (IMF) every ten years or so. The economy was able to weather a number of pressures – internal and external – such as the South Asian crisis of 1997-98, the synchronised global economic slowdown in 2000-02, the drought of 2002-03 and the periodic spurts in international oil prices – in isolation and in combination - and still emerged as one of the fastest growing economies among the emerging market economies in the world. As you are well aware, oil prices had recently crossed US $ 55 a barrel – and yet, while there may be some inflationary pressure, there is no concern about the sustainability of the balance of payments.

The Indian economy clocked a growth rate of 8.2 per cent during 2003-04. We have exceeded the 8.0 per cent barrier only thrice before – 1967-68, 1975-76 and 1988-89. While base effects of a low agricultural production in the previous year are indeed important, the fact is that the high growth rate of 2003-04 was pretty much widespread drawing from industry, services and exports. There are now indications that the economy will be able to achieve a growth rate of 6.0-6.5 per cent this year, putting us again on an average 7.0 per cent trajectory.

It is necessary to underscore the fact that increase in growth has been accompanied by a sharp fall in the average inflation rate to 5.8 per cent during 1994-95 to 2003-04, which was far below the long-run average of about 8.0 percent during the 1970s-90s. While price stability is important in any economy because fluctuations in nominal values affect business decisions, it is all the more important in a country like India where the poor have no hedges against inflation. It is only natural that as a central banker, this should be of particular satisfaction to me.

Broadbasing Growth

A second key positive outcome has been the broadbasing of the growth process. First of all, *per capita* income has been rising by about 4.0 per cent during the post-reform period as compared with a measly 1.3 per cent growth during 1951-80. While this was aided by a distinct deceleration in the compound growth rate of population from 2.14 per cent during the decade ending 1991 to 1.96 per cent during the decade ending 2001, the higher growth rate also had a role to play. Be that as it may, this is increasingly reflected in a significant reduction in the poverty ratio to 26.1 per cent in 1999-2000 from 36.0 per cent in 1993-94 and 38.9 per cent in 1987-88.

Growing National Confidence

Thirdly, there is a sea change in the way we perceive ourselves and in the way the world now perceives India. Although India was always an important player in world diplomacy as a leader of the Non-Aligned Movement, our international image was, to an extent, constrained by our economic vulnerability. The key difference now is that the possibility of emerging as an economic power is now adding to our stature as a key voice of peace.

In a sense, the three years of 7.0 per cent real GDP growth during the mid-1990s was an eye-opener which galvanised us as a people. Empirical studies already suggest that India could well grow at close to seven per cent during 2005-2025. It is not a coincidence that the medium term growth strategy, outlined in the Tenth Five Year Plan (2002-07) is to achieve an even more ambitious growth target of 8 per cent per annum over the Tenth Plan period.

It will be appreciated that the closed economy with which we had fortified our economy was essentially out of a fear that we would not be able to compete with the advanced economic systems. Another recurrent fear was that opening our capital account would be a sure invitation to capital flight. As the experience of the 1990s has shown, neither of the fears were true and in fact, the experience was quite the opposite. Instead of harping on “appropriate” second hand technology transfers as in the past, this has given us the confidence to benchmark ourselves with the very best worldwide. This is especially so in the financial sector where a Standing Committee on International Standards and Codes found that our regulations are, more or less, comparable with best international practices.

Our increasing confidence is mirrored by the growing interest that the world is taking in the Indian economy as an investment destination. Foreign investment has grown to 3.0 per cent of GDP from virtually negligible levels in

1990-91. It is not a coincidence that India attracted the maximum portfolio investment to Asia in 2003 – with the exception of Korea.

Foreign Exchange Reserves

Finally, buttressing the national and international confidence is the fact that in the management of the external sector, India has a striking success story to tell. As I said earlier, Indian openness, measured as the ratio of current receipts and expenditures to GDP, at 37.2 per cent by 2003-04 (20 per cent in 1990-91) – is higher than that of the American economy at about 26 per cent. There can be very little disagreement that the overall objective of external sector reforms of achieving higher growth and efficiency without exposing the system to greater vulnerability is reasonably in the bird's eye of fruition.

The merits of our cautious approach to globalisation are now widely recognised. We did not require reversal of policies towards the capital account as was the case with some emerging market economies that had followed a relatively rapid liberalisation without entrenching the necessary preconditions. It is commendable for the macroeconomic management of the external sector that in marked contrast to the balance of payments crisis of 1991, when default was perceived as a real threat, a major issue of debate in the country, today, is the need for such a large size of foreign exchange reserves. Indeed, the International Monetary Fund has classified India as a creditor country under the Financial Transaction Plan in February 2003.

The process of opening up of the Indian economy is taking place in sure and steady steps. Trade liberalisation, involving withdrawal of quantitative restrictions, tariffs cuts and simplification of procedures, compatible with World Trade Organisation (WTO) commitments, is now globalising production systems in the Indian economy. This is complemented by a market-based exchange rate regime since March 1993. This was followed by the convertibility of the Indian rupee for current account transactions, codified by the acceptance of Article VIII of the Articles of Agreement of the IMF in

August 1994. Finally, capital account convertibility has proceeded apace, especially as we view it as a process rather than as an event. At present, the *de facto* full capital account convertibility for non-residents is supported by the calibrated liberalisation of transactions undertaken for capital account purposes in the case of residents.

There is very little doubt that almost all indicators of external sector suggest our growing strength. One of the factors underlying the external payments crisis of 1991 was the high levels of current account deficit (CAD) maintained during the 1980s. Following concerted efforts, the current account deficit averaged only 0.6 per cent of GDP during 1994-95 to 2003-04 as compared with 1.8 per cent in the 1980s. The current account actually recorded a surplus in 2001-02 after a period of 23 years and this has persisted for three years in a row. Secondly, key indicators of debt sustainability point to the continuing consolidation and improved solvency in the 1990s. As at end-March 2004, the external debt to GDP ratio declined sharply from 28.7 per cent at end-March 1991 to 17.6 per cent at end-March 2004. Thirdly, the behavior of the exchange rate, which came to be determined by the market in March 1993, has remained largely orderly. The present Indian regime of managed flexibility that focuses on managing volatility without reference to any target has gained increasing international acceptance. Finally, there is, of course, the fact that India now has foreign exchange reserves of over US $ 120 billion, which is the sixth largest in the world, and is a far cry from the situation of August 1991 when foreign exchange reserves were only about US $ 0.8 billion.

Is the process of economic reforms a new morning or a false dawn? It is now time to turn to the darker side of the picture – and it must be recognised that the challenges are just as many as the achievements.

Challenge of employment generation

The most fundamental challenge of the process of economic growth is to convert itself into a process of economic development. A key disappointment

of the process of economic reforms has been its inability to generate employment in the Indian economy. Unemployment statistics tabulated by the Ahluwalia Task Force suggest that unemployment rate in India in the year 1999-00 was placed at 7.3 per cent of the total labour force on a current daily status basis. There is virtually no improvement from the past: 8.2 per cent in 1977-78 and 6 per cent in 1993-94.

There is, thus, an imperative need to step up investment in job-oriented industries. The Tenth Five Year Plan targets, among others, agriculture, and construction for high growth in view of their potential for employment generation with relatively low capital intensity. The present emphasis on infrastructure projects – construction and power generation – appear to be steps in the right direction.

It cannot be overemphasised that a mechanism of distribution of the national wealth is central to the process of sustained increase in national wealth. It is also necessary to approach the issue with a great deal of sensitivity. There is a point of view that labour reforms would spur employment because capital could then be freed from the sunset industries to set up sunrise industries. It must be understood, however, that labour reforms without social safety nets could be a virtual invitation to social unrest.

Poor Human Development

A second challenge is that we continue to have the dubious distinction of housing about a quarter of the world's poor. Although India ranks as one of the leading countries in the world in terms of purchasing power parity, we are among the lower middle to low in per capita income measured in either standard or purchasing power terms. In 2003, our *per capita* GNP, was only US $ 530 and ranked 160th in the world (out of 208 countries). Although our *per capita* GNP rises to US $ 2,880, on purchasing power parity basis, we still rank 143rd in the world.

Human development indicators remain just as dismal. The dichotomy between the economy's significance in the world economic order because of its large size and the relative destitution of the average Indian as compared with his peers in the group of say, the top fifteen largest economies is, after all, very real. There are some indications that the Indian human and social indicators, in terms of the average life expectancy, infant mortality rate and schooling, are edging up over the years in the absolute terms. It is, however, a matter of concern that in relative terms we seem to be pretty much stuck in similar rankings. We ranked 127th of 177 countries in 2002 in terms of the Human Development Index. In terms of the Human Poverty Index, which measures the extent of deprivation, rather than development, as of 2002, for 95 developing countries, we were at the 48th position.

It is essential to realise that the challenge of human capital is now more important than ever before. A key factor driving the international interest in the Indian economy is the possibility of a demographic dividend – the benefits of having a relatively young and working population. The total dependency ratio (proportion of people below 15 years or above 59 years to the working age populations (15-59)) is likely to decline from 62.5 per cent in 2000 to 46.1 per cent in 2025 before rising back to 52.6 per cent in 2050. It is in this context that there are several reports – of which the BRICs report from Goldman Sachs is only one – which suggests that Brazil, Russia, India and China could emerge as major economic super-powers by 2050. While it is true that India is in line for a demographic dividend, a careful look at the data suggest that the dividend is likely to emanate from the demographic profile of the poor and populous states of Bihar, Madhya Pradesh, Rajasthan and Uttar Pradesh. This only reinforces my previous point that employment generation holds the key to future economic progress in our country.

Fiscal Deficit

A third major concern is the size of the fiscal deficit. The key factor driving the structural imbalances of the 1980s, it may be recalled, was said to be the profligacy of the fisc. In the earlier half of the 1990s, there was actually an improvement in the fiscal position but over time things have again deteriorated to the bad old days. The combined gross fiscal deficit of the Centre and the States has actually followed a perfect U curve during the 1990s, falling from 9.4 per cent of GDP in 1991 to 6.5 per cent in 1995-96 before picking up again to 9.4 per cent of 2003-04.

It could well be argued that high fiscal deficits are not *per se* bad. Public investment could, after all, crowd in private investment by providing infrastructural facilities. This only goes to highlight the bigger concern that the capital outlay has actually declined from 13.1 per cent of total expenditure in 1991 to 11.0 per cent in 2003-04. Development expenditure has similarly fallen to 15.9 per cent of total expenditure in 2003-04 from 17.4 per cent in 1990-91. Another concern is that the expenditure on education as percentage of total expenditure of general government (*i.e.*, the Centre and States combined) has fallen from 10.4 per cent in 1990-91 to 9.9 per cent in 2002-03.

There is, of course, a silver lining on the horizon. The budget estimates for 2004-05 place the combined gross fiscal deficit at 7.9 per cent of GDP, almost 150 basis points lower than the 2003-04 levels. The Fiscal Responsibility and Budget Management Act, 2003 now plans to reduce the fiscal deficit and eliminate the revenue deficit by 2008 and thereafter build up a revenue surplus. Under the Act, the Central Government has framed the Fiscal Responsibility and Budget Rules 2004 which set annual targets for phased reduction in deficit indicators over the next few years. Sub-national fiscal reforms are also gathering momentum through a twin-track strategy of a co-ordination approach and an autonomous approach. The Centre supports States' fiscal reforms through a Medium-Term Fiscal Reforms Programme. A number of States, such as Karnataka, Kerala, Punjab, Tamil Nadu and Uttar Pradesh have enacted enabling legislation during 2002-03 to provide a statutory backing to fiscal reforms.

Agriculture Investment

Yet another challenge is the deceleration in agricultural growth, which as will be realised, is linked to the issues of poverty alleviation and fiscal adjustment. While it is true that the importance of agriculture declines as the economy matures, the fact is that almost two thirds of Indians do depend on agriculture for their livelihood. It is indeed a matter of debate whether the decline in the share of agriculture in GDP is a reflection of the acceleration in the other sectors or whether it is a result of the slowdown in agricultural investment *per se*.

Consider the facts. Agricultural growth slowed down to 2.5 per cent during the post-reform period of 1992-2002 from 3.1 per cent in the 1980s, even despite 13 years of good monsoons up to 2002. A variety of factors are said to have contributed: inadequate irrigation cover; improper adoption of technology, unbalanced use of inputs; decline in public investment; and weakness in the credit delivery system.

There is no denying that the finger of suspicion really points to a secular decline in the rate of investment in agriculture. Capital formation in agriculture as a ratio of GDP originating from agriculture also decreased from 8.5 per cent in 1980-81 to 6.1 per cent in 2000-01. This has been driven by the steep decline in the ratio of public sector capital formation in agriculture to gross public sector capital formation from 17.7 per cent in 1980-81 to 7.1 per cent in 1990-91 and further only to 4.9 per cent in 2000-01.

As I have pointed out earlier, the Government is now taking a number of initiatives to step up investment in agriculture. At the Reserve Bank, we are also taking a number of measures to improve the credit delivery system for the rural sector, especially since studies show that usurious interest rates of above 30 per cent continue to persist in rural credit. It is in this context that the

Reserve Bank is implementing the recommendations of the Vyas Committee on Agricultural Credit.

Emerging Issues

Finally, let me turn to the emerging issues that come out of an analytical survey of the Indian reforms process in the past twelve years. There is, of course, very little disagreement that the Indian macroeconomic performance has indeed been credible. At the same time, there is no denying that the challenges are many and just as great.

First, there is little doubt that India is well on the path of a take-off. As a nation, we missed the bus of the original Industrial Revolution in the 19th century and most of the repeats in the 20th century. It is therefore necessay to ensure that our comparative advantage in the on-going revolution in communications and information technology is nurtured to its logical conclusion.

Second, while it is true that we stand at the cutting edge of information technology, there is no denying that this is not enough to buffet an economy as large and as populous as ours. While services have so far provided an impetus for growth, the tertiary sector cannot surely expand in isolation. There is, thus, clearly need for greater investment in agriculture and industry.

Thirdly, the need to ensure a degree of equity is central to the process of economic growth because of the social imbalances it tends to foster. The gains from the process of economic liberalisation must be spread more evenly over the different strata and must especially carry disadvantaged sections of the society along with it. Public policy thus has a role to play in ensuring an equitable spread of growth. There is, in particular, a need to strengthen the process of human capital formation not only in the cities but also in the countryside.

Finally, it is necessary to keep the tryst with destiny. It is important to appreciate that the projections of Indian economic growth are not necessarily as

far-fetched as they appear to be. A study by Maddison shows that India accounted as much as 22.6 per cent of the world production as late as 1700. The Indian sub-continent, of course, sank into an abyss of poverty during the centuries of colonial subjugation and our output is below 5 per cent of world production. In a sense, the very colonial subjugation itself resulted from an inability to ride the powerful forces of industrialisation which had then begun to appear on the horizon. We must not let that happen now.