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AN ASSESMENT OF SOME ECONOMIC THOUGHT IN INDIAN ECONOMY IN THE CONTEXT OF ECONOMIC REFORMS

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ABSTRACT

Within the constraints of democratic politics and the relatively 'soft' nature of the economic reforms implemented since 1991, the Indian economy has reaped several welcome rewards from its reforms. These have strengthened the conviction that the broad direction of the reforms is right and, in that sense, made the reform process irreversible. However, India needs to launch a 'second generation' of economic reforms, with a more human face, if it is to reap their full potential. Politicians and administrators need to display greater pragmatism while designing and implementing future economic reforms. The economy of India is the twelfth largest economy in the world by market exchange rates and the fourth largest by purchasing power of the people. India was under socialist-based policies for an entire generation from the 1950s until the 1980s. The economy was characterised by extensive regulation, protectionism, and public ownership, leading to pervasive corruption and slow growth. Since 1991, continuing economic liberalization has moved the economy towards a market-based system.

INTRODUCTION

India's large service industry accounts for 54% of the country's GDP while the industrial and agricultural sector contribute 29% and 17% respectively. Agriculture is the predominant occupation in India, accounting for about 60% of employment. The service sector makes up a further 28% and industrial sector around 12%. The labor force totals half a billion workers. Major agricultural products include rice, wheat, oilseed, cotton, jute, tea, sugarcane, potatoes, cattle, water buffalo, sheep, goats, poultry and fish. Major industries include textiles, chemicals, food processing, steel, transportation equipment, cement, mining, petroleum, machinery, information technology enabled services and software.

India's per capita income is $1016, ranked 142nd in the world, while it's per capita purchasing power of the people is US$2762, ranked 129th. Previously a closed economy, India's trade has grown fast. India currently accounts for 1.5% of World trade as of 2007 according to the WTO. According to the World Trade Statistics of the WTO in 2006, India's total merchandise trade (counting exports and imports) was valued at $294 billion and India's services trade inclusive of export and import was $143 billion. Thus, India's global economic engagement in 2006 covering both merchandise and services trade was of the order of $437 billion, up by a record 72% from a level of $253 billion in 2004. India's trade has reached a still relatively moderate share 24% of GDP in 2006, up from 6% in 1985.

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India ranks second worldwide in farm output. Agriculture and allied sectors like forestry, logging and fishing accounted for 16.6% of the GDP in 2007, employed 60% of the total workforce and despite a steady decline of its share in the GDP, is still the largest economic sector and plays a significant role in the overall socio-economic development of India. Yields per unit area of all crops have grown since 1950, due to the special emphasis placed on agriculture in the five-year plans and steady improvements in irrigation, technology, application of modern agricultural practices and provision of agricultural credit and subsidies since Green revolution in India. However, international comparisons reveal that the average yield in India is generally 30% to 50% of the highest average yield in the world.

India is fifteenth in services output. It provides employment to 23% of work force, and it is growing fast, growth rate 7.5% in 1991–2000 up from 4.5% in 1951–80. It has the largest share in the GDP, accounting for 55% in 2007 up from 15% in 1950. Business services (information technology, information technology enabled services, business process outsourcing) are among the fastest growing sectors contributing to one third of the total output of services in 2000. The growth in the IT sector is attributed to increased specialization, and an availability of a large pool of low cost, but highly skilled, educated and fluent English-speaking workers, on the supply side, matched on the demand side by an increased demand from foreign consumers interested in India's service exports, or those looking to outsource their operations. The share of India's IT industry to the country's GDP increased from 4.8% in 2005-06 to 7% in 2008. In 2009, seven Indian firms were listed among the top 15 technology outsourcing companies in the world. In March 2009, annual revenues from outsourcing operations in India amounted to US$60 billion and this is expected to increase to US $225 billion by 2020.

According to World Trade Organization, India accounted for 1.2% of the global trade in 2006. Until the liberalization of 1991, India was largely and intentionally isolated from the world markets, to protect its economy and to achieve self-reliance. Foreign trade was subject to import tariffs, export taxes and quantitative restrictions, while foreign direct investment was restricted by upper-limit equity participation, restrictions on technology transfer, export obligations and government approvals; these approvals were needed for nearly 60% of new FDI in the industrial sector. The restrictions ensured that FDI averaged only around US$200 million annually between 1985 and 1991; a large percentage of the capital flows consisted of foreign aid, commercial borrowing and deposits of non-resident Indians. India's exports were stagnant for the first 15 years after independence, due to the predominance of tea, jute and cotton manufactures, demand for which was generally inelastic. Imports in the same period consisted predominantly of machinery, equipment and raw materials, due to nascent industrialization.

Since liberalization, the value of India's international trade has become more broad-based and has risen to Rs. 63080109 crores in 2003–04 from Rs.1250 crores in 1950–51. India's major trading partners are China, the US, the UAE, the UK, Japan and the EU. The exports during

April 2007 were $12.31 billion up by 16% and import were $17.68 billion with an increase of 18.06% over the previous year.

Cumulative Current Account Balance 1980-2008 based on the IMF data since independence, India's balance of payments on its current account has been negative. Since liberalisation in the 1990s (precipitated by a balance of payment crisis), India's exports have been consistently rising, covering 80.3% of its imports in 2002–03, up from 66.2% in 1990–91. India's growing oil import bill is seen as the main driver behind the large current account deficit. In 2007-08, India imported 120.1 million tonnes of crude oil, more than 3/4th of the domestic demand, at a cost of $61.72 billion.

Although India is still a net importer, since 1996–97, its overall balance of payments (i.e., including the capital account balance), has been positive, largely on account of increased foreign direct investment and deposits from non-resident Indians; until this time, the overall balance was only occasionally positive on account of external assistance and commercial borrowings. As a result, India's foreign currency reserves stood at $285 billion in 2008, which could be used in infrastructural development of the country if used effectively.

Due to the global late-2000s recession, both Indian exports and imports declined by 29.2% and 39.2% respectively in June 2009. Since the decline in imports was much sharper compared to the decline in exports, India's trade deficit reduced to $252.5 billion. India's reliance on external assistance and commercial borrowings has decreased since 1991–92, and since 2002–03, it has gradually been repaying these debts. Declining interest rates and reduced borrowings decreased India's debt service ratio to 4.5% in 2007. In India, External Commercial Borrowings (ECBs) are being permitted by the Government for providing an additional source of funds to Indian corporate.

Development of infrastructure was completely in the hands of the public sector and was plagued by corruption, bureaucratic inefficiencies, urban-bias and an inability to scale investment. India's low spending on power, construction, transportation, telecommunications and real estate, at $31 billion or 6% of GDP in 2002 had prevented India from sustaining higher growth rates. This has prompted the government to partially open up infrastructure to the private sector allowing foreign investment which has helped in a sustained growth rate of close to 9% for the past six quarters. Some 600 million Indians have no mains electricity at all. While 80% of Indian villages have at least an electricity line, just 44% of rural households have access to electricity. According to a sample of 97,882 households in 2002, electricity was the main source of lighting for 53% of rural households compared to 36% in 1993. Some half of the electricity is stolen, compared with 3% in China. The stolen electricity amounts to 1.5% of GDP. Almost all of the electricity in India is produced by the public sector. Power outages are common. Many buy their own power generators to ensure electricity supply. As of 2005 the electricity production was at 661.6 billion kWh with oil production standing at 785,000 bbl/day. In 2007, electricity demand exceeded supply by 15%.Multi Commodity Exchange has tried to get a permit to offer electricity future markets.

Internet use is rare; there were only 2.1 million broadband lines in India in January 2007. Most urban cities have good water supply water 24 hours a day, while some smaller cities face water shortages in summer season. A World Bank report says it is an institutional problem in water agencies, or "how the agency is embedded in the relationships between politics and the citizens who are the consumers."

One of the critical problems facing India's economy is the sharp and growing regional variations among India's different states and territories in terms of per capita income, poverty, availability of infrastructure and socio-economic development. Seven low-income states - Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, Orissa, Rajasthan, and Uttar Pradesh - are home to more than half of India's population. Between 1999 and 2008, the annualized growth rates for Gujarat (8.8%), Haryana (8.7%), or Delhi (7.4%) were much higher than for Bihar (5.1%), Uttar Pradesh (4.4%), or Madhya Pradesh (3.5%). Poverty rates in rural Orissa (43%) and rural Bihar (40%) are some of the worst in the world. On the other hand, rural Haryana (5.7%) and rural Punjab (2.4%) compare well with middle-income countries. The five-year plans have attempted to reduce regional disparities by encouraging industrial development in the interior regions, but industries still tend to concentrate around urban areas and port cities.

There has also been a shift in the composition of banking sector credit against the agriculture sector. The share of agriculture credit to total credit declined from 22% in 1990-01 to 16.2% in 2000-01. Although it has seen a rise since then, currently the share is still at 20.5% in 2007-08. This is largely due to shift in the focus of scheduled commercial banks from rural to urban sectors. During study it has been observed sustained rise in the share of credit to service sector from 8.6% in 1990-91 to 13.2% in 2007-08. Increasing competition in the banking sector and rise in the NPAs in agriculture credit appears to have contributed to this shift. But the public policy interventions through priority sector lending and other policies appears to have had minimal impact on ensuring more credit to agriculture.

By transforming their production and employment activities, access to finance can enable people to exit poverty. In order to support this, the (RBI imposed a license rule in 1977 which stated that for each branch opened in a banked location (typically urban), commercial banks had to open four branches in un banked location (typically rural). This rule was removed in 1990 and branch building in rural areas came to a halt. This seems to be one of the reasons for this drop in credit/investment in the agriculture sector. The number of bank branches in the rural areas has declined from 57% in 1990-91 to 41% in 2007-08. This has also resulted in rise in urban and metropolitan regions from 24% to 37% in the same period (see graph below). This shows that the banking operations appear to have shifted from rural to urban regions.

The impact of ten years of economic reforms in India presents a mixed picture. The industrial and trade policy reforms have gone far, though they need to be supplemented by labor market reforms, which are a critical missing link. The logic of liberalization also needs to be extended to agriculture, where numerous restrictions remain in place. Reforms aimed at encouraging private investment in infrastructure have worked in some areas, but not in others. The complexity of the problems in this area was underestimated, especially in the power sector. This has now been recognized, and policies are being reshaped accordingly. Progress has been made in several areas of financial sector reforms, though some of the critical issues relating to government ownership of the banks remain to be addressed. However, the outcome in the fiscal area shows a worse situation at the end of ten years than at the start. Critics often blame the delays in implementation and failure to act in certain areas to the choice of gradualism as a strategy. However, gradualism implies a clear definition of the goal and a deliberate choice of extending the time taken to reach it, to ease the pain of transition. This is not what happened in all areas. The goals were often indicated only as a broad direction, with the precise end point and the pace of transition left unstated to minimize opposition—and possibly also to allow room to retreat, if necessary. This reduced politically divisive controversy and enabled a consensus of sorts to evolve, but it also meant that the consensus at each point represented a compromise, with many interested groups joining only because they believed that reforms would not go "too far." The alternative would have been to have a more thorough debate with the objective of bringing about a clearer realization on the part of all concerned of the full extent of change needed, thereby permitting more purposeful implementation. However, it is difficult to say whether this approach would indeed have yielded better results, or whether it would have created gridlock in India's highly pluralist democracy.

It has been argued that the growth spurt prior to 1991 was fragile and volatile. There was a jump in the growth rate during 1977–79, a massive decline in 1979–80, a jump again in 1980–82, a return to the Hindu rate during 1982–88 except 1983–84, a climb up again in 1988–91, and a crisis in 1991–92. This volatility in the growth pattern itself raises doubts about the sustainability of a 5 percent plus growth rate over the long haul. The 1991 crisis only confirmed the fundamental weakness of the underlying forces ex post. In contrast, growth during the 1990s has been more robust, exhibiting far less volatility. Whereas in the late 1980s, many observers of India were betting on a crisis any time, there are few takers of such a bet today. Despite well-known vulnerabilities resulting from fiscal deficits that are as large today as in the late 1980s and slow pace of banking reforms, few pundits are predicting an external crisis today. The external-debt-to-GDP ratio has been declining and foreign-exchange reserves at more than $100 billion exceed the currency in circulation.

The acceleration of growth during the 1980s relative to that in the preceding decades was not achieved without important policy changes. In contrast to the isolated ad hoc policy measures taken to release immediate pressures prior to the 1980s, the measures in the last half of the 1980s, taken as a whole, constituted a significant change and an activist reform program. For example, by 1990, approximately 20 percent of the tariff lines and 30 percent of the imports had come under OGL with significant exemptions on tariffs accruing to the OGL products. Import licensing on many other products was also considerably eased up.19 As regards industrial licensing, 31 sectors had already been freed from it by 1988 with 27 sectors remaining subject to it. By 1988, significant liberalizing steps had also been taken toward freeing up the large-sized firms by raising the asset limit defining the MRTP firms fivefold and opening a number of avenues for the license-free entry of MRTP firms in many sectors. The increase in the asset limit freed 90 out of 180 large firms from the MRTP restrictions altogether. The 1980s' reforms and their success provided crucial first-hand evidence to policy makers that gradual liberalization can deliver faster growth without causing disruption. In turn, this evidence gave policy makers confidence in undertaking the bolder and more far-reaching reforms in the 1990s.

Since the financial reforms of 1991, there have been significant favorable changes in India's highly regulated banking sector. The empirical estimation showed that regulation lowered the profitability and cost efficiency of public-sector banks at the initial stage of the reforms, but such a negative impact disappeared once they adjusted to the new environment.

The above results suggest that the current policy of restructuring the banking sector through encouraging the entry of new banks has so far produced some positive results. However, the fact that competition has occurred only at the lower end suggests that bank regulators should conduct a more thorough restructuring of public-sector banks. Given that public-sector banks have scale advantages, the current approach of improving their performance without rationalizing them may not produce further benefits for India's banking sector. As 20 years have passed since the reforms were initiated and public-sector banks have been exposed to the new regulatory environment, it may be time for the government to take a further step by promoting mergers and acquisitions and closing unviable banks. A further reduction of SLR and more encouragement for non-traditional activities may also make the banking sector more resilient to various adverse shocks.

Implications of Financial Sector Reforms

The Indian financial system of the pre-reform period essentially catered to the needs of planned development in a mixed-economic framework where the Government sector had a predominant role in economic activity. As part of planned development, the macro-economic policy in India moved from fiscal neutrality to fiscal activism (Reddy 2000). Such activism meant large developmental expenditures, much of it to finance long-gestation projects requiring long-term finance. The sovereign was also expected to raise funds at fine rates, and understandably at below the market rates for private sector. In order to facilitate the large borrowing requirements of the Government, interest rates on Government securities were artificially pegged at low levels, which were unrelated to market conditions. The government securities market, as a result, lost its depth as the concessional rates of interest and maturity period of securities essentially reflected the needs of the issuer (Government) rather than the perception of the market. The provision of fiscal accommodation through ad hoc treasury bills (issued on tap at 4.6 per cent) led to high levels of monetisation of fiscal deficit during the major part of the eighties. In order to check the monetary effects of such large-scale monetisation, the cash reserve ratio (CRR) was increased frequently to control liquidity.

The environment in the financial sector in these years was thus characterised by segmented and underdeveloped financial markets coupled with paucity of instruments. The existence of a complex structure of interest rates arising from economic and social concerns of providing concessional credit to certain sectors resulted in "cross subsidisation" which implied that higher rates were charged from non-concessional borrowers.

Competition

Steps have also been initiated to infuse competition into the financial system. The RBI issued guidelines in 1993 is respect of establishment of new banks in the private sector. Likewise, foreign banks have been given more liberal entry. Recently, the norms for entry of new private banks were rationalised. Two new private sector banks have been given 'in-principle' approval under these revised guidelines. The Union Budget 2002-03 has also provided a fillip to the foreign banking segment, permitted these banks, depending on their size, strategies and objectives, to choose to operate either as branches of their overseas parent, or, corporatize as domestic companies. This is expected to impart greater flexibility in their operations and provide them with a level-playing field vis-à-vis their domestic counterparts.

Regulation and Supervision

A second major element of financial sector reforms in India has been a set of prudential measures aimed at imparting strength to the banking system as well as ensuring safety and soundness through greater transparency, accountability and public credibility.

Capital adequacy norms for banks are in line with the Basel Committee standards and from the end of March 2000, the prescribed ratio has been raised to 9 per cent. While the objective has been to meet the international standards, in certain cases, fine-tuning has occurred keeping in view the unique country-specific circumstances. For instance, risk weights have been prescribed for investment in Central Government securities on considerations of interest rate risk. Also, while there is a degree of gradualism, there is an intensification beyond the 'best practices' in several instances in recent period, an example being exposure norms stipulated for the banking sector in respect of investment The supervisory strategy of the Board for Financial Supervision (BFS) constituted as part of reform consists of a four-pronged approach, including restructuring system of inspection, setting up of off-site surveillance, enhancing the role of external auditors, and strengthening corporate governance, internal controls and audit procedures. The BFS, in effect, integrates within the Reserve Bank the supervision of banks, NBFCs and financial institutions.

Fiscal Policy and Financial Sector

There are several channels that link the fiscal and financial sectors and in the Indian context five of them appear significant. These relate to (a) governments' borrowing programme; (b) guarantees extended by governments; (c) mechanisms such as 'direct debits'; and (d) governments' investments in financial sector.

The market borrowing programme of the central government continued to be relatively large, both in gross and net terms. Since a large part of the borrowing programme has to be completed in the first half of the fiscal year, in view of seasonality for demand for credit on private account, the monthly average borrowing by centre is around three quarters of a percent of GDP in recent years. Further, there has been an upward revision in the borrowing programme of central government during the course of every year, usually, around three quarters of a percent of GDP. It has been possible for RBI as debt manager to complete the borrowing programme while pursuing its interest rate objectives without jeopardizing external balance, by recourse to several initiatives in terms of institution, instruments, incentives and tactics. At the same time, it has been able for RBI to reduce statutory preemptions in regard to banks to the prescribed minimum of 25% of their net liabilities. The banking system, in which PSBs account for about three quarters of activity, holds majority of the outstanding stock of government securities, and currently their holdings in excess of statutory prescriptions are far in excess of the annual borrowing programme of the Central and State Governments. In any case, a large part of outstanding government securities are held by Government owned financial institutions, especially in banking and insurance sectors. RBI has so far been able to successfully reconcile the interests of Government as its debt manager and of banks as regulator and supervisor. In this regard, recognizing the importance of containing interest rate risks and widening the participant profile, RBI has prescribed an Investment Fluctuation Reserve for banks and is pursuing retailing of government securities. While technological, institutional and procedural bottlenecks for retailing are being overcome by RBI, some of the constraints such as tax treatment and relatively high administered interest rates do persist.

In this regard, extra budgetary transactions are also emerging, which impinge on the balance sheets of banks and other financial institutions which take an exposure on them. For example, "oil bonds" to settle government's dues to public sector oil companies and "power bonds" to settle dues from State Electricity Boards to national level power utilities fall in this category. Banks exposure to food credit, which is in the nature of funding of buffer stock operations is also relatively large at over 2.0% of GDP. RBI had been advocating that a law be passed imposing a ceiling on government borrowings as enabled by the Constitution, but more recently, a Bill is under contemplation for fiscal responsibility at the centre and several states.

Financial intermediaries, especially banks, take exposures with a great degree of comfort when there is a sovereign guarantee. Such guarantees are often formally extended and notified as such to the legislative bodies and financial markets. RBI has encouraged governments to pass a legislation prescribing a ceiling on such guarantees and also charge a fee without exception to ensure credibility to guarantees and comfort to subscribers. Several State Governments have passed such legislations, though some are less stringent than others. In view of the magnitudes of such guarantees by many States, banks have been advised to exercise due diligence in subscribing to them. Apart from explicit guarantees, recourse is occasionally made by governments to letters of comfort which have a similar effect, and RBI has been dissuading such relatively non-transparent practices.

There are, in addition, what may be termed as "implicit-guarantees" which have maximum linkage between fiscal and financial sectors. A predominant point of financial intermediation through banks, mutual funds, and insurance, in spite of significant reform is undertaken by publicly owned or government backed financial institutions. Hence, public tend to repose confidence with a corresponding implicit direct obligation on the part of government to protect the interests of depositors or investors. Such a reasonable expectation is not only justified on the considerations of reputation risk and the concept of "holding out' or backing, but also by the obligations discharged in the past by the Government of India, in several cases; some of them at the instance of regulator concerned.

The governments have, in its asset portfolio, equity holding and some debts of financial intermediaries that they own, and financial returns on these do impact the fiscal situation. More important, whenever pockets of vulnerability arise in financial sector, the headroom available in the fiscal situation to provide succour to financial entities needs to be assessed. Fortunately, on present reckoning, the magnitudes of the few pockets of vulnerability appear to be manageable without undue fiscal strain.

In assessing fiscal financial linkage, the scope for money financing of budgets vis-à-vis bond financing also needs to be considered. Since there are elements of open capital account, the maneuverability for RBI in the short-term to monetize government's deficit is severely circumscribed by the direction and magnitudes of such flows. Keeping these considerations in view, RBI and Government have agreed upon freedom to RBI to determine the extent of monetization of government budget consistent with macro-economic stability.

SUGGESTIONS

Despite robust economic growth, India continues to face several major problems. The recent economic development has widened the economic inequality across the country. Despite sustained high economic growth rate, approximately 80% of its population lives on less than $2 a day (PPP), more than double the same poverty rate in China. Even though the arrival of Green Revolution brought end to famines in India, 40% of children under the age of three are underweight and a third of all men and women suffer from chronic energy deficiency While the credit rating of India was hit by its nuclear tests in 1998, it has been raised to investment level in 2007 by S&P and Moody's. In 2003, Goldman Sachs predicted that India's GDP in current prices will overtake France and Italy by 2020, Germany, UK and Russia by 2025 and Japan by 2035. By 2035, it is projected to be the third largest economy of the world, behind US and China.

The Government has to decide what it wants to do with its ownership of public sector financial institutions. Lack of funds will force its to divest its stake over a period, but this may mean only a slow death for the institutions involved. The political and bureaucratic establishment has to be convinced that they are doing more harm than good by interfering in the management of these institutions. Otherwise even after reduction of its equity stake to 33 per cent, the public sector character of banks will remain unchanged! Offices such as Department of Banking need to be wound up, with regulators taking control. Senior level appointments have to be made by the respective boards of directors by accessing the market place, and offering market related salaries and incentives. The board of directors, based on performance, should renew senior level appointments. The institutions should have the right to forcibly retire existing non-performing employees, and new staff should be recruited without guaranteeing life-time employment. Even the threat of action will improve performance and productivity.

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