Two Decades of Economic Reform in India

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In the center of India's flag, sits a spinning wheel - a symbol used by Gandhi to protest English textile imports under colonial rule and to demonstrate the ability of a society of small-scale agriculture and industry. India's economy was governed by the principle of the spinning wheel for much of its independence. On the Indian flag, the spinning wheel adorning India's colors in a powerful testament to the historically vital linkages between India's economy and its political identity. The spinning wheel symbolizes economic and political independence, dearly held values that have driven India's approach to economic policy since Independence.

India's independence in 1947 and the appointment of the Indian National Congress party heralded a new era of economic policy dedicated to *"self-sufficiency"*. Often described as the "third way" or "mixed economy", Nehru established a blend of democratic politics and central planning. India's pride in its then evolving economic reforms is best manifested by the following statement attributed to Nehru: "a second-rate Indian good is superior to a first-rate foreign product." Nehru established state ownership and import-substitution industrialization in hopes of developing India's internal capacity.

However, India's socialistic planning failed to develop a strong economy and efficient institutions. Waste and corruption flourished in the country. The state bureaucracy became known as the *"License Raj"* because its comprehensive scheme of licenses, required for all business activities, created fertile ground for widespread bribes and political kickbacks.

While economic growth rate in many Asian nations surged, India's growth rate was approximating at a sluggish 3% and was deridingly termed as the "Hindu rate of growth".

The 1991 Balance of Payment (BOP) crisis was the "tipping point" in India's economic history. India was forced to procure $1.8 billion loan from the International Monetary Fund (IMF). The bailout wounded India's pride and thwarted the country's policies of "self-sufficiency". India's policy failures were now glaring across the Indian policymakers and the world.

In response to the crisis, the government immediately introduced stabilization measures to reduce the fiscal deficit. Fiscal tightening and devaluation of the rupee by 25% adequately reduced the current account deficit. Though the foreign exchange reserve recovered quickly and ended effectively the temporary clout of the IMF and the World Bank, reforms continued in a stop-go fashion. The government has since initiated a reversal of the historic policies of regulation and government intervention.

The economic liberation reform, initiated by Manmohan Singh in 1991, is considered to be one of the milestones of Indian economic reform as it changed the market and financial scenario of the country. Foreign Direct Investment was encouraged, public monopolies were stopped, and service and tertiary sectors were developed. It was not until 1991 that the government signaled a systematic shift to a more open economy with greater reliance upon market forces, a larger role for the private sector including foreign investment, and a restructuring of the role of the government. In the 10 year period from 1992-93 to 2001-02, the average growth rate of the country was around 6%, which puts India amongst the fastest growing developing economies of the 1990s.

Main Economic Reforms of 1991-93:

- Fiscal
    - Reduction of fiscal deficit
    - Launching of reform of major taxes
- External Sector
    - Devaluation and transition to a market-determined exchange rate
    - Phased reduction of import licensing (quantitative restrictions)
    - Phased reduction of peak custom duties
    - Policies to encourage direct and portfolio foreign investment
    - Monitoring and controls over external borrowing, especially short-term
    - Build-up of foreign exchange reserves
    - Amendment of the Foreign Exchange Regulation Act (FERA) to reduce restrictions on firms
- Industry
    - Virtual abolishing of industrial licensing
    - Abolition of separate permission needed by “MRTP houses”
    - Sharp reduction of industries “reserved” for the public sector
    - Freer access to foreign technology
- Agriculture
    - More remunerative procurement prices for cereals
    - Reduction in protection to manufacturing sector
- Financial Sector
    - Phasing in of Basel prudential norms
    - Reduction in reserve requirements for banks, notably the cash reserve ratio (CRR) and the statutory liquidity ratio (SLR)
    - Gradual freeing up of interest rates
    - Legislative empowerment of the Securities and Exchange Board of India (SEBI)
    - Establishment of the National Stock Exchange (NSE)
    - Abolition on government control over capital issues
- Public Sector
    - Disinvestment program begun
    - Greater autonomy / accountability for public enterprises

Fiscal Deficit Reduction - Fiscal Discipline

Fiscal laxity, growing reliance on external borrowing, a weakening financial sector, and heavy-handed regulation of trade and industry are well known. In Gulf war in the second half of 1991 was the proximate trigger, which jacked up international oil prices, and also India's import bill, also reducing remittance inflows from the Gulf. At the start of the reforms, a reduction in the fiscal deficit was an urgent priority. The combined fiscal deficit of the central and state governments was successfully reduced from 9.4% of GDP in 1990-91 to 7% in both 1991-92 and 1992-93 and the BOP crisis was over by 1993.

The reforms also had a medium term objective of improving public savings so that essential public investment could be financed with a smaller fiscal deficit to avoid "crowding out" private investment.

India's fiscal reform focused on revenue-related issues like rationalizing the tax structure and increasing compliance. The government had to subsequently abandon their initial attempts to curb the deficit through spending cuts, and by 1996, the annual deficit had climbed back to the 1991 levels -- 10.5% of GDP. The vicious cycle of over-expenditure and poorly targeted spending was tough to break.

The Central Government fiscal deficit had expanded steadily during the eighties and had reached a peak level of 7.84% of GDP in 1990-91. Allowing for deficits of the State Governments, this meant an overall fiscal deficit of around 10% which is a very high figure. For the reforms to take off, it was critical for the Central Government's fiscal deficit to be controlled. The first year of the reforms saw a substantial reduction in the fiscal deficit to 5.5% of the GDP in 1991-92 and further to 5.34% of GDP in 1992-93 (Data Source: RBI).

Some of the reduction in deficit in the first two years was achieved through systemic improvements which permanently strengthened the fiscal situation,

e.g., the abolition of export subsidies in 1991-92 and the partial restructuring of the fertilizer subsidy in 1992-93

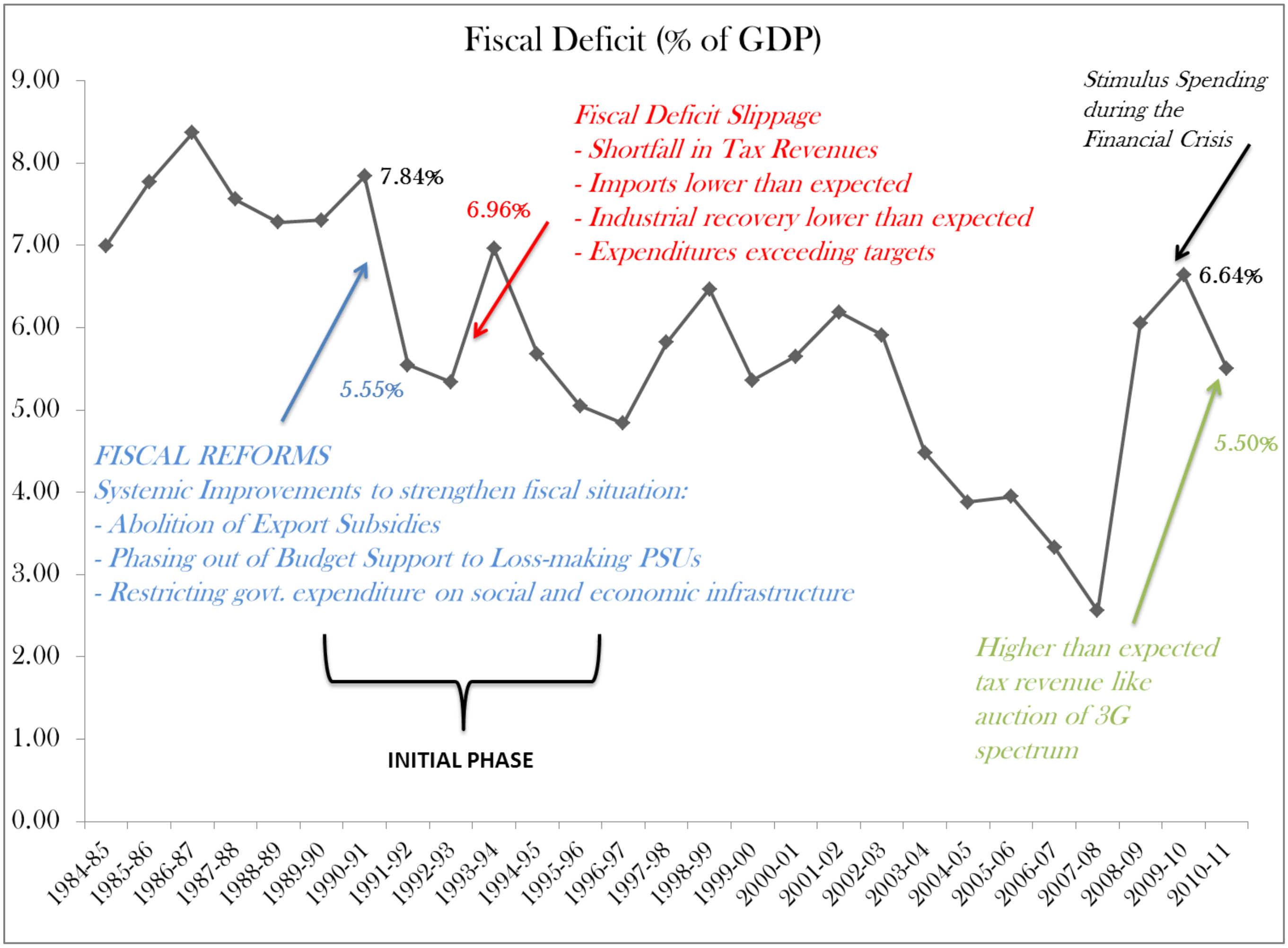
Another important systems change was the announcement of the phasing out of budget support to loss-making PSUs which were provided in the form of government loans in order to cover their losses.

However, part of the fiscal adjustment in the first two years was also achieved by restricting government expenditure on social and economic infrastructure.

Despite the above limitation, it was commendable to witness the reduction in fiscal deficit by almost 2.6% of GDP. This process of fiscal consolidation was to continue but there was a substantial slippage in the target (of 4.6%) and fiscal deficit increased to 6.9% of GDP in 1993-94. Part of this slippage can be attributed to a shortfall in tax revenues compared to Budget targets. Imports were much lower than expected, despite reductions in customs duty rates and liberalization, due to which customs revenues were substantially below the target. Industrial production did not recover as rapidly as expected leading to a shortfall in the excise duty collections. A substantial part of the slippage can also be attributed to expenditures exceeding targets. Higher food subsidies resulted due to delays in adjusting food prices in the public distribution system and development expenditures on states was also higher than expected.

The current level of fiscal deficit as a percentage of GDP is around 5.5%. The estimate has been further reduced to 4.6% of GDP for 2011-12. The current year's reduction in deficit from 6.64% in 2009-10 to 5.5% in 2010-11 is chiefly attributed to the higher than expected tax revenue like auction of 3G and

Broadband Wireless Access spectrum (that garnered Rs. 1.08 lakh crore). The high fiscal deficit of 6.64% in 2009-10 was chiefly due to ballooning of the stimulus spending worth billions of dollars to combat the global meltdown. The government also followed the path of consolidation during April-December 2010-11, as it partially withdrew the sops given to the industry in 2008 and 2009.



Year	Gross Fiscal Deficit (% of GDP)
1989-90	7.31
1990-91	7.84
1991-92	5.55
1992-93	5.34
1994-95	5.68
2001-02	6.19
2007-08	2.56
2008-09	6.05
2009-10	6.64
2010-11	5.50

Industrial and International Trade Policy Reforms (including Foreign Investment):

It can be safely said that the most radical changes implemented in the reform package have been in the area of Industrial Policy - removing several barriers to entry in the earlier environment. Earlier there existed the system of pervasive industrial licensing requiring government's permission for new investments as well as for substantial expansion of existing capacity; that system has been virtually abolished. Only a small list of industries now requires licensing, primarily due to environmental and pollution concerns.

The parallel but separate controls over the Monopolies and Restrictive Trade Practices (MRTP) Act have also been eliminated. The Companies Act is also under continuous and comprehensive restructuring which aims at simplifying and modernizing the legal framework governing the corporate sector.

The list of industries reserved for the public sector has been pruned drastically and many critical areas have been opened up to private sector participation. The list of industries reserved solely for the public sector -- which used to cover 18 industries, including iron and steel, heavy plant and machinery, telecommunications and telecom equipment, minerals, oil, mining, air transport services and electricity generation and distribution -- has been drastically reduced to three: defense aircrafts and warships, atomic energy generation, and railway transport. Electric power generation was also opened up for private investment, as also the hydrocarbon sector, covering petroleum exploration, production, and refining. Privatization of air transport and also the opening up of the telecommunications sector to private players has been a significant milestone in the government's public-private partnership initiative.

However, the main area where the action has been inadequate relates to the long standing policy of reserving production of certain items for the small-scale sector. Moreover, industrial liberalization by the central government needs to be accompanied by supporting action by state governments. Complaints of delays, corruption, and harassment arising from interaction between private players and the state government are very common. Differences across states have resulted in variation in state growth rates, with some of the less favored states actually decelerating compared to the 1980s. Since liberalization has created a more competitive environment, the pay-off from pursuing good policies has increased and this calls for the increasing importance of state-level action. Deficiencies in governance need immediate attention.

The reformed policies are much more supportive of foreign investment in India. India's trade policy prior to 1991 was characterized by high tariffs and import restrictions. Foreign-manufactured consumer goods were entirely banned, and capital goods, raw materials, and intermediate goods for which domestic substitutes existed were importable only through a bureaucratic licensing process.

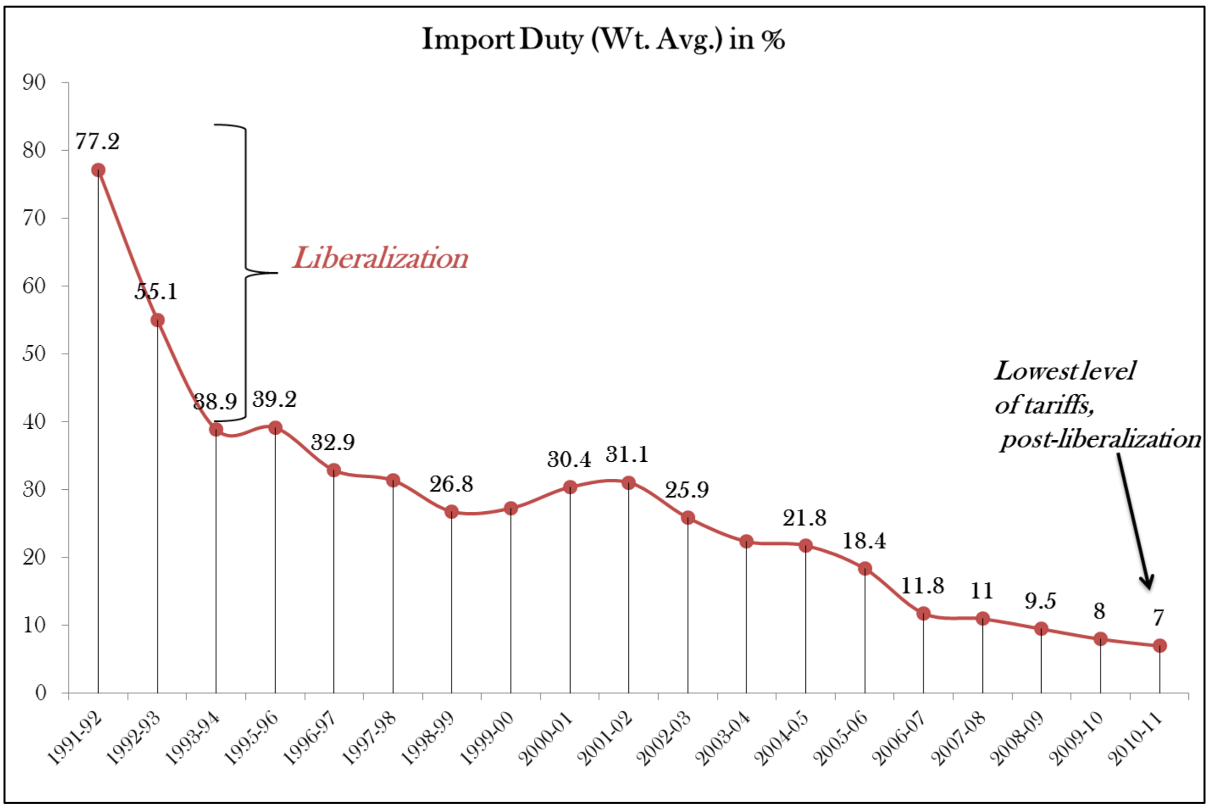
Illustrative of the severity of the situation, Infosys executives described how the founders had to visit Delhi nine times to obtain a license to import just one personal computer.

Import licensing was abolished relatively early for capital goods and intermediates which became freely importable in 1993, simultaneously with a switch to the flexible exchange rate regime. Traditionally, import licensing had been defended on the grounds that it was necessary to manage the balance of payments. However, the shift to the flexible exchange rate system enabled the government to argue that balance of payments impacts would now be handled through exchange rate flexibility.

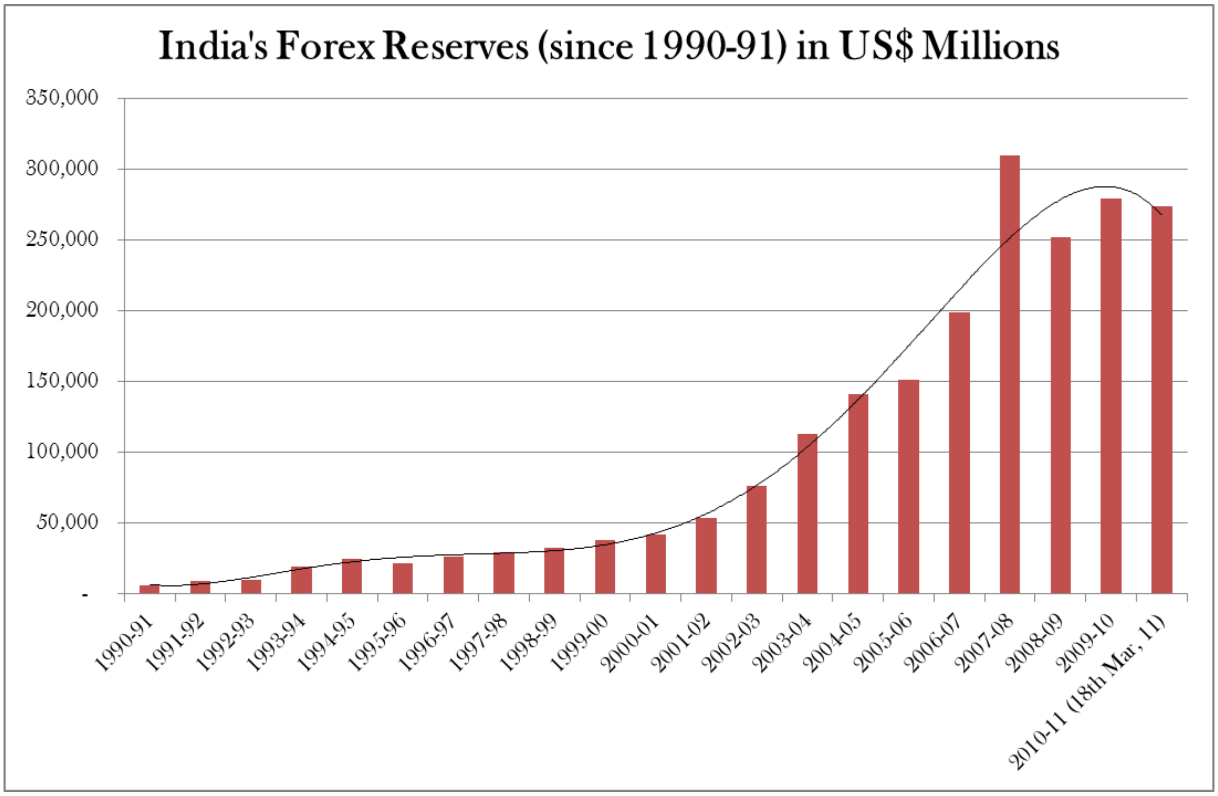
Quantitative restrictions on imports were removed relatively easily in the case of capital goods and intermediaries due to the small number of domestic producers in India who welcomed the move. However, similar liberalizations in the consumer goods sector proved to be difficult because the number of producers who would be affected by the move was very large; this was partly because much of the consumer goods industry was reserved for the small scale sector.

On April 1, 2001, quantitative restrictions on imports of manufactured consumer goods were finally removed because of a ruling by the World Trade Organization dispute panel on a complaint brought by the United States.

The reforms have led to a significant reduction in tariff protection in the country; the weighted average import duty rate in India was 77.2% in 1991-92, which has been brought down to 7% in 2009-10. India has and should continue to take advantage of the World Trade Organization as a cover against domestic backlash to further tariff reductions.



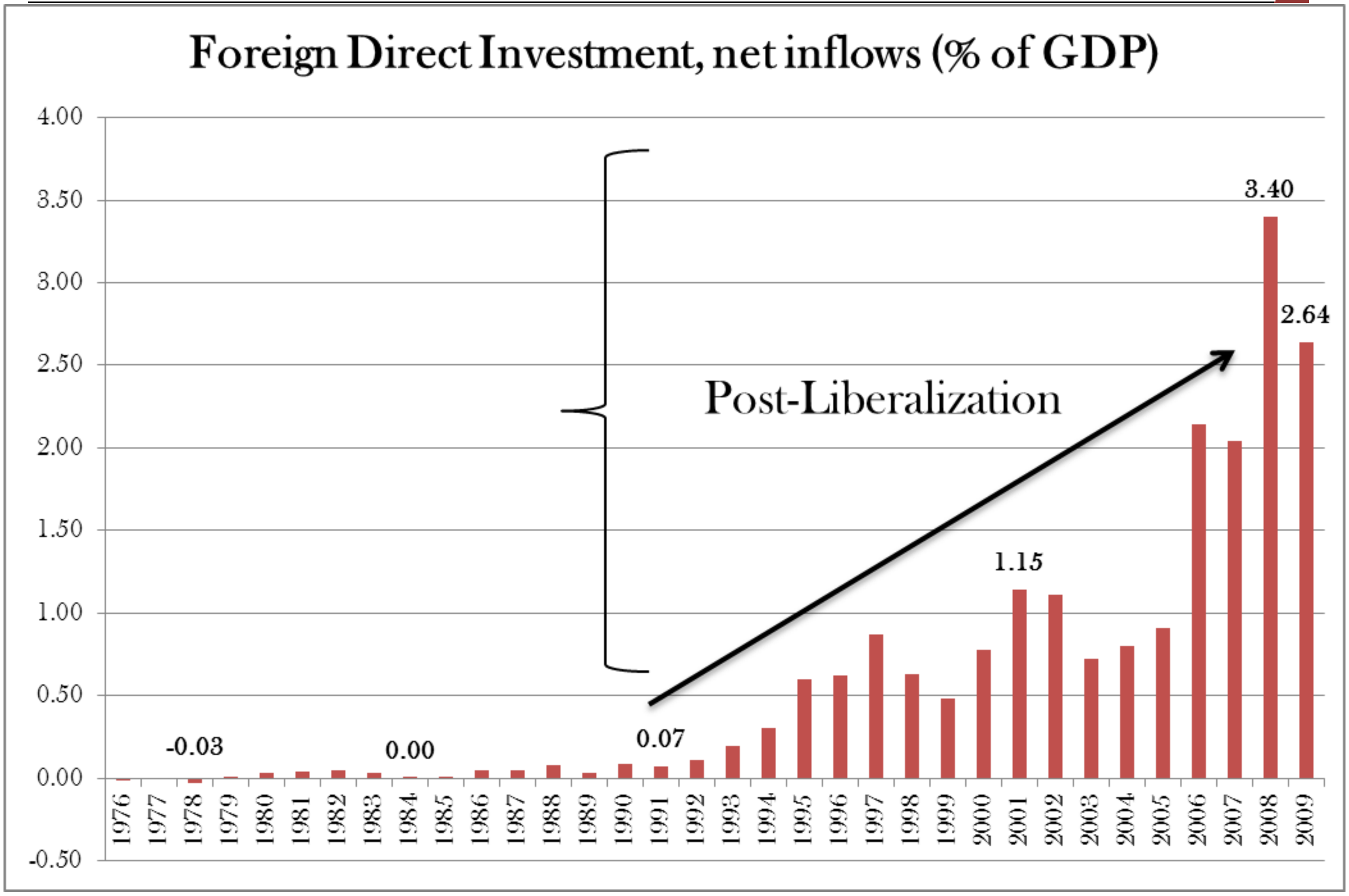
The Exchange Rate policy of India has gone through a series of transitional regimes since 1991, leading to a total transformation at the end of three years. The regimes began with a devaluation of about 24% in July 1991 in a situation in which extensive trade restrictions were still in place. The devaluation was accompanied by an abolition of export subsidies to help the fiscal position, and an offsetting increase in export incentives. In a short span of two and a half years, the trade and payments system moved from a fixed and typically overvalued exchange rate operating in a framework of substantial trade restrictions and export subsidies, to a market determined exchange rate within a framework of considerable liberalization on the trade account and the elimination of restrictions.

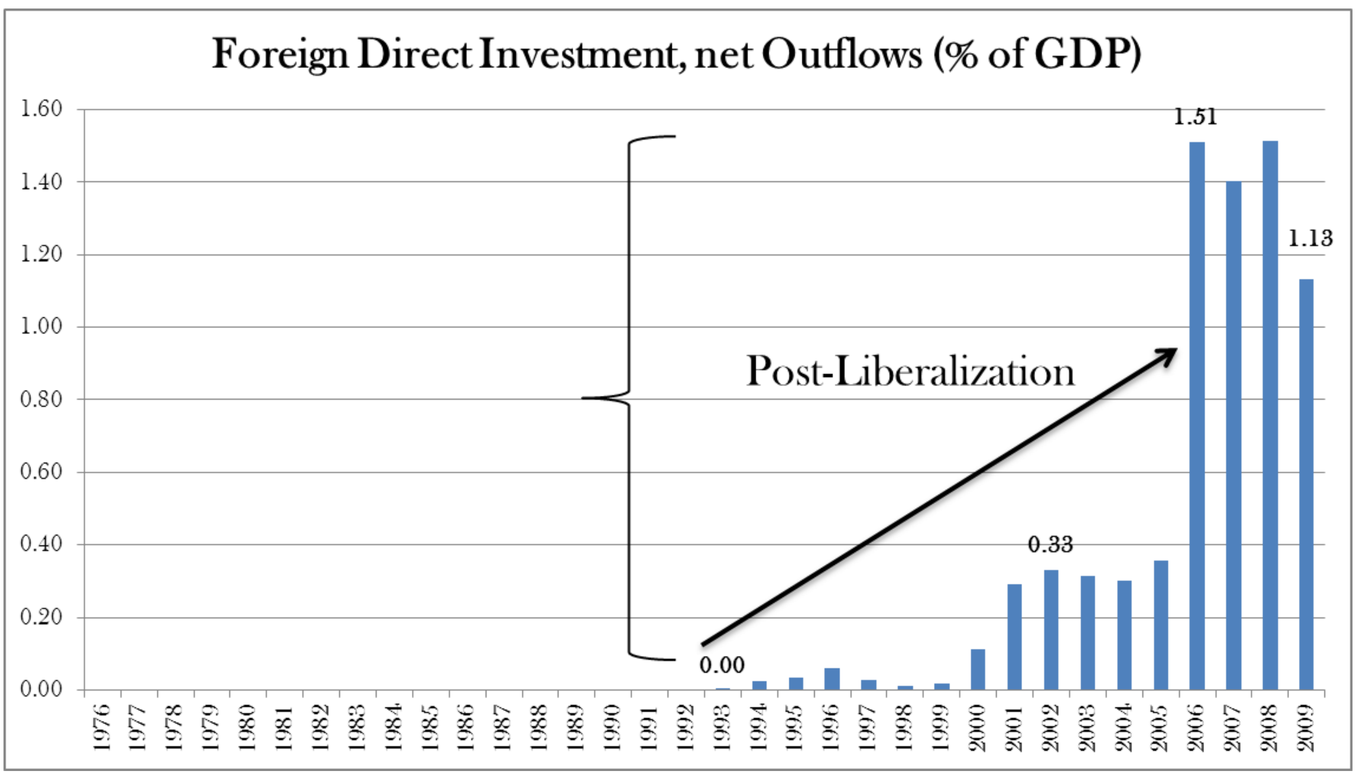


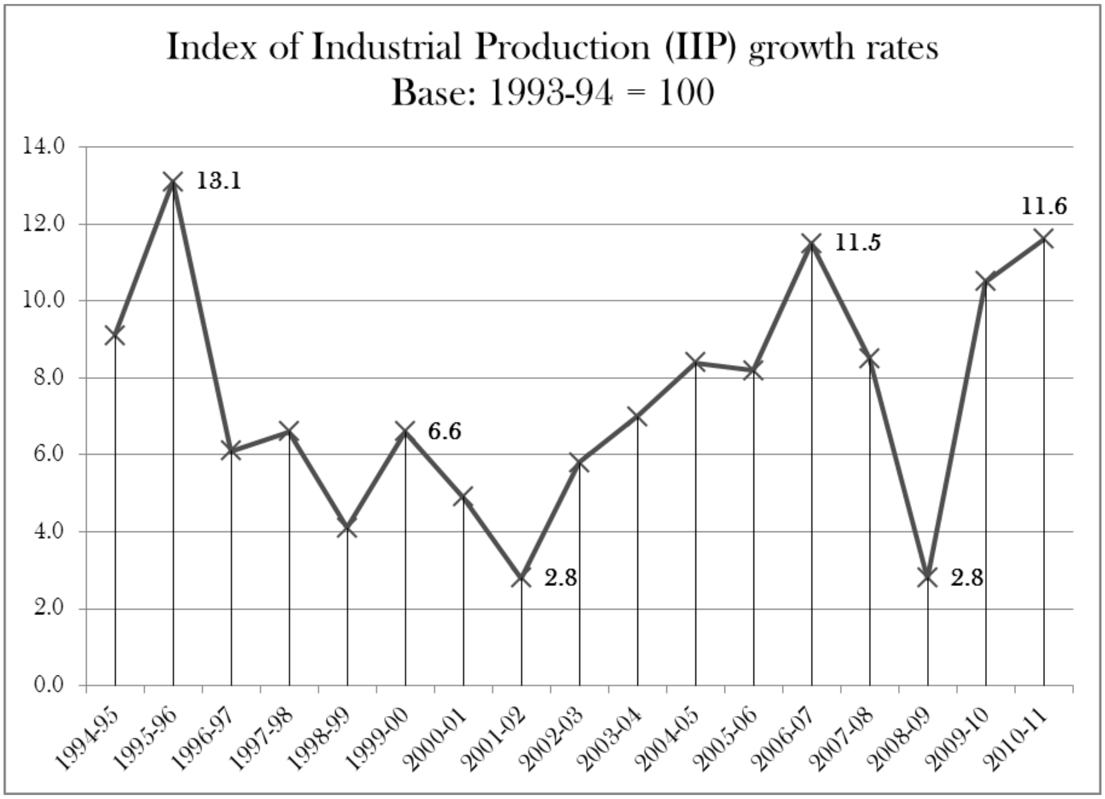
The liberalization of controls over domestic investors has been accompanied by a radical restructuring of the policy toward foreign investment. Earlier, India's policy towards foreign investment was selective and foreigners perceived it to be unfriendly. The percentage of equity allowed to foreign investors was generally restricted to a maximum of 40%, except in certain high technology areas, and foreign investment was generally discouraged in the consumer goods sector unless accompanies by strong export commitments.

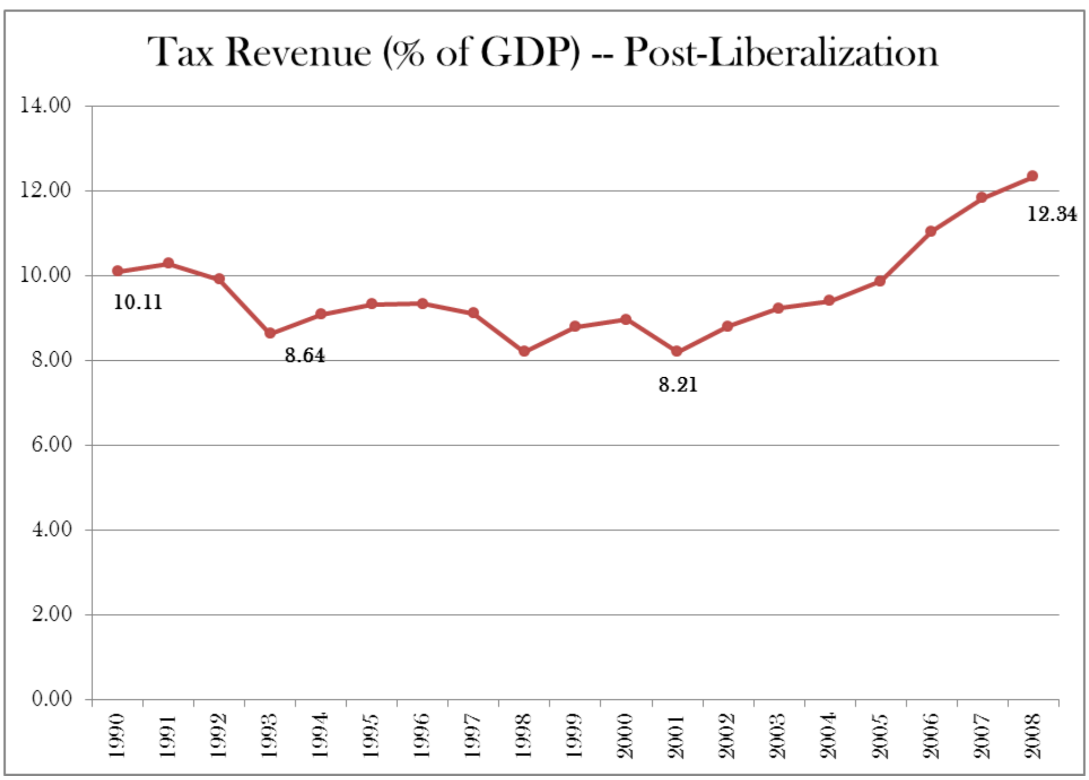
Liberalizing FDI was an important part of India's economic reforms, fuelled by the belief that this would increase the total amount of investment in the economy, improve technology, and improve access to world markets. 100% foreign ownership is now allowed in a large number of industries.

Although foreign ownership in some Indian companies was permitted, investors faced complications that included a subjective licensing process, high regulation upon approval, and equity-holding caps. In fact, until recently Indians had only one television program and had to settle for locally-produced "Thums Up" instead of Coca-Cola.


Foreign Direct Investment, net inflows (% of GDP)
Post-Liberalization
3.40
2.64
1.15
0.07
0.00
-0.03
4.00
3.50
3.00
2.50
2.00
1.50
1.00
0.50
0.00
-0.50
1976 1977 1978 1979 1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009

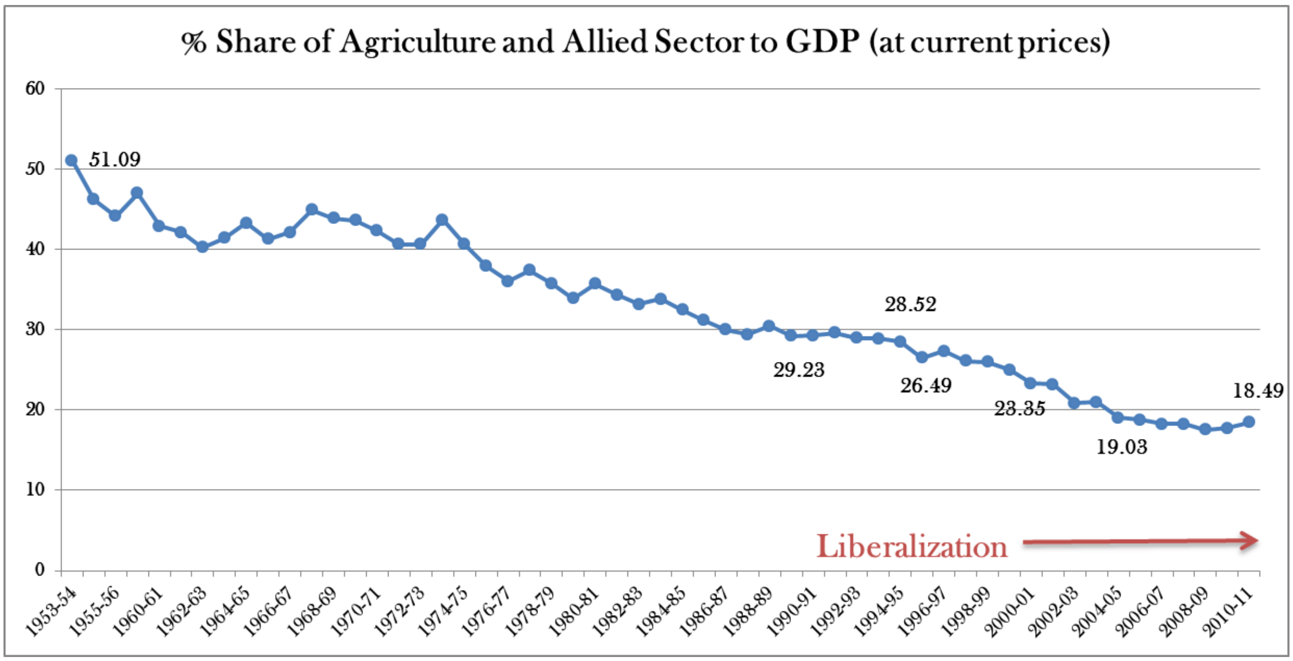

Foreign Direct Investment, net Outflows (% of GDP)
Post-Liberalization
1.51
1.13
0.33
0.00
1.60
1.40
1.20
1.00
0.80
0.60
0.40
0.20
0.00
1976 1977 1978 1979 1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009


Index of Industrial Production (IIP) growth rates
Base: 1993-94 = 100
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
13.1
11.6
11.5
6.6
2.8
2.8
1994-95
1995-96
1996-97
1997-98
1998-99
1999-00
2000-01
2001-02
2002-03
2003-04
2004-05
2005-06
2006-07
2007-08
2008-09
2009-10
2010-11

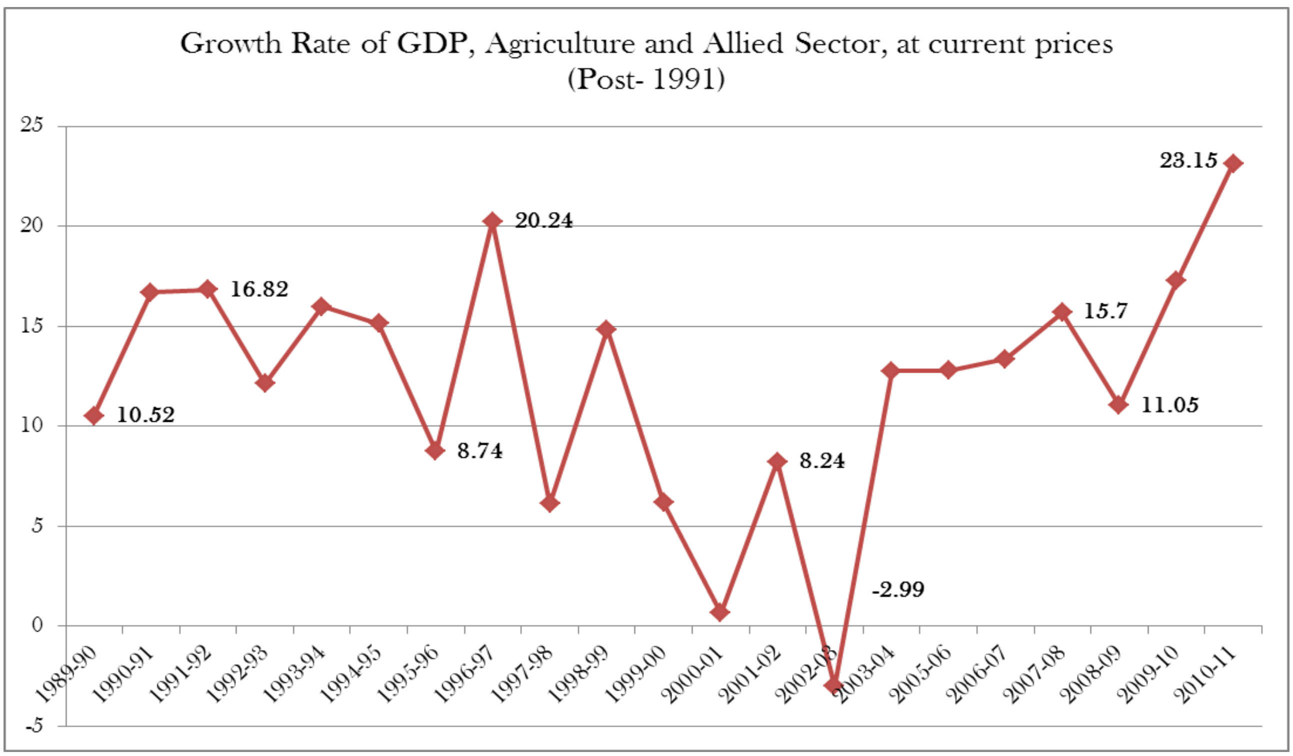

Tax Revenue (% of GDP) -- Post-Liberalization
14.00
12.00
10.00
8.00
6.00
4.00
2.00
0.00
12.34
10.11
8.64
8.21
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008

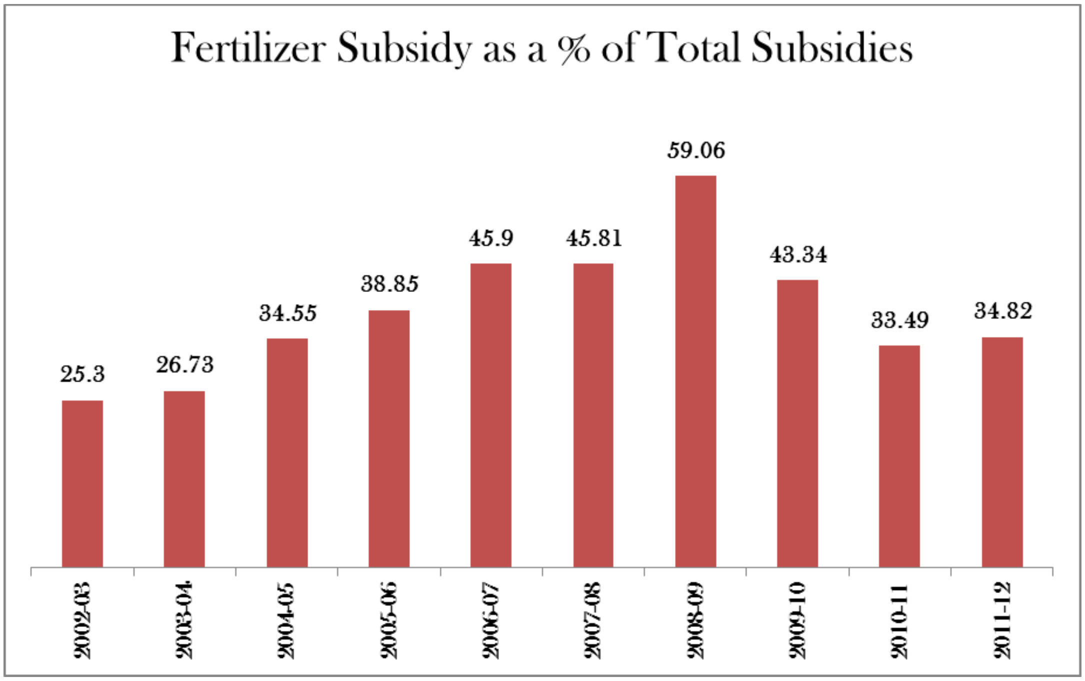
Reforms in Agriculture:

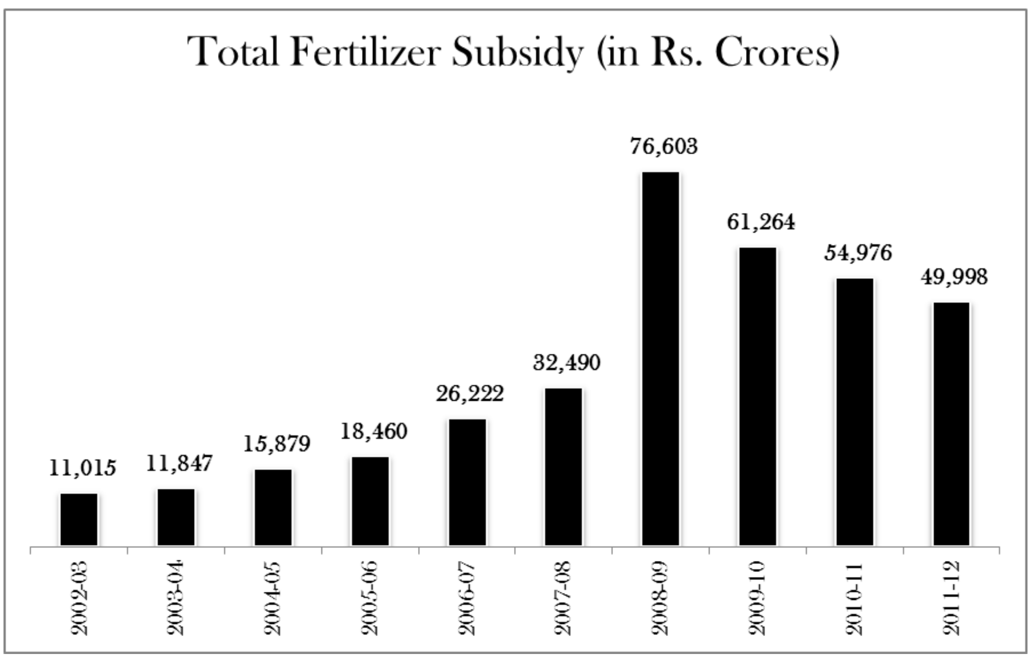
A common criticism of India's economic reforms is that they have been excessively focused on industrial and trade policy, neglecting agriculture which provides the livelihood of around 60% of the population. Critics point to the deceleration in agricultural growth in the second half of the 1990s as proof of this neglect. India's reforms are often unfavorably compared with the very different sequencing adopted in China, which began with reforms in agriculture in 1978, extending them to industry only in 1984. The comparison is not entirely fair since Chinese agriculture faced an extremely distorted incentive structure, with virtually no role for markets, which provided an obvious area for high priority action with potentially large benefits. Since Indian agriculture operated to a much greater extent under market conditions, the situation was very different.



Despite the fact that agriculture accounts for only about 19% of India's GDP, the agricultural sector has always been politically influential. Agricultural subsidies for poor farmers have been part of the Indian landscape since independence. The support system for farmers includes large fertilizer subsidies, free electrical power, protection for land owners, and minimum price guarantees for grain production. While these programs allowed India to avoid famine in the 1970s, they have created perverse incentives and opportunities for corruption. Fertilizer subsidies have contributed to over-fertilization and contamination of ground water. Additionally, subsidies often do not reach the target populations. In Delhi, for example, many affluent neighborhoods have been classified as rural areas and receive free electricity. Finally, subsidized prices have led to the overgrowth of certain crops. The Indian government makes inefficient purchase of food staple crops at above-market prices with the intention of redistributing them to the poor. But such goods rarely reach their intended destination, due to corruption and inefficiencies.




Fertilizer Subsidy as a % of Total Subsidies
25.3
26.73
34.55
38.85
45.9
45.81
59.06
43.34
33.49
34.82
2002-03
2003-04
2004-05
2005-06
2006-07
2007-08
2008-09
2009-10
2010-11
2011-12


Total Fertilizer Subsidy (in Rs. Crores)
11,015
11,847
15,879
18,460
26,222
32,490
76,603
61,264
54,976
49,998
2002-03
2003-04
2004-05
2005-06
2006-07
2007-08
2008-09
2009-10
2010-11
2011-12

Financial Sector Reform:

India's reform program included wide-ranging reforms in the banking system and the capital markets relatively early in the process with reforms in insurance introduced at a later stage.

Banking sector reforms included:

(a) Measures for liberalization, like dismantling the complex system of interest rate controls, eliminating prior approval of the Reserve Bank of India for large loans, and reducing the statutory requirements to invest in government securities;
(b) Measures designed to increase financial soundness, like introducing capital adequacy requirements and other prudential norms for banks and strengthening banking supervision;
(c) Measures for increasing competition like more liberal licensing of private banks and freer expansion by foreign banks.

These steps have produced some positive outcomes. There has been a sharp reduction in the share of non-performing assets in the portfolio and more than 90% of the banks now meet the new capital adequacy standards. However, these figures may overstate the improvement because domestic standards for classifying assets as non-performing are less stringent than international standards.

Government control over commercial banking has always been frowned upon by skeptics, who insist that bank managers are bound to respond to political directions if their career advancement depends on the government.

Even if the government does not interfere directly in credit decisions, government ownership means managers of public sector banks are held to standards of accountability akin to civil servants, which tend to emphasize compliance with rules and procedures and therefore discourage innovative decision making. Regulatory control is also difficult to exercise.

The unstated presumption that public sector banks cannot be shut down means that public sector banks that perform poorly are regularly recapitalized rather than weeded out. This obviously weakens market discipline, since more efficient banks are not able to expand market share.

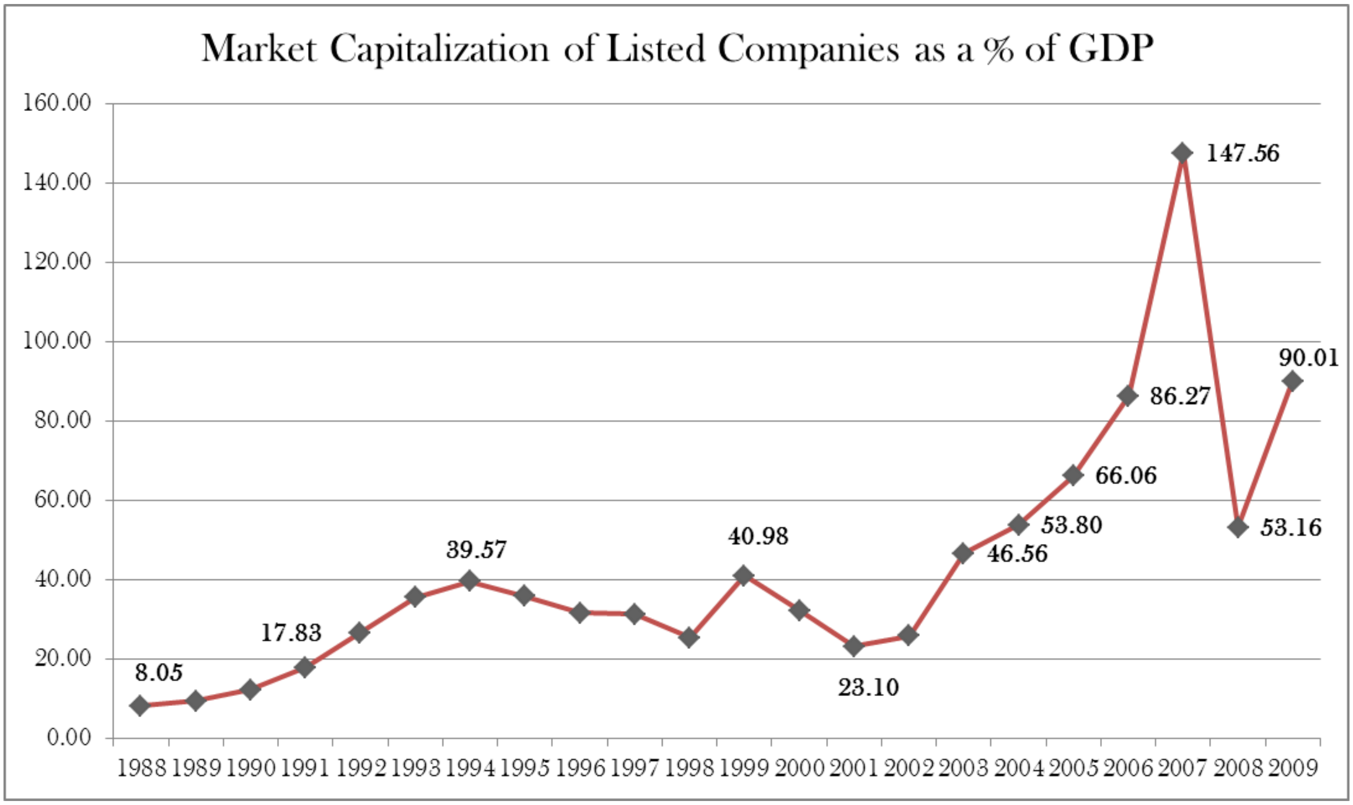
The legal framework is another major factor limiting the efficiency of banks, making it difficult for creditors to enforce their claims.

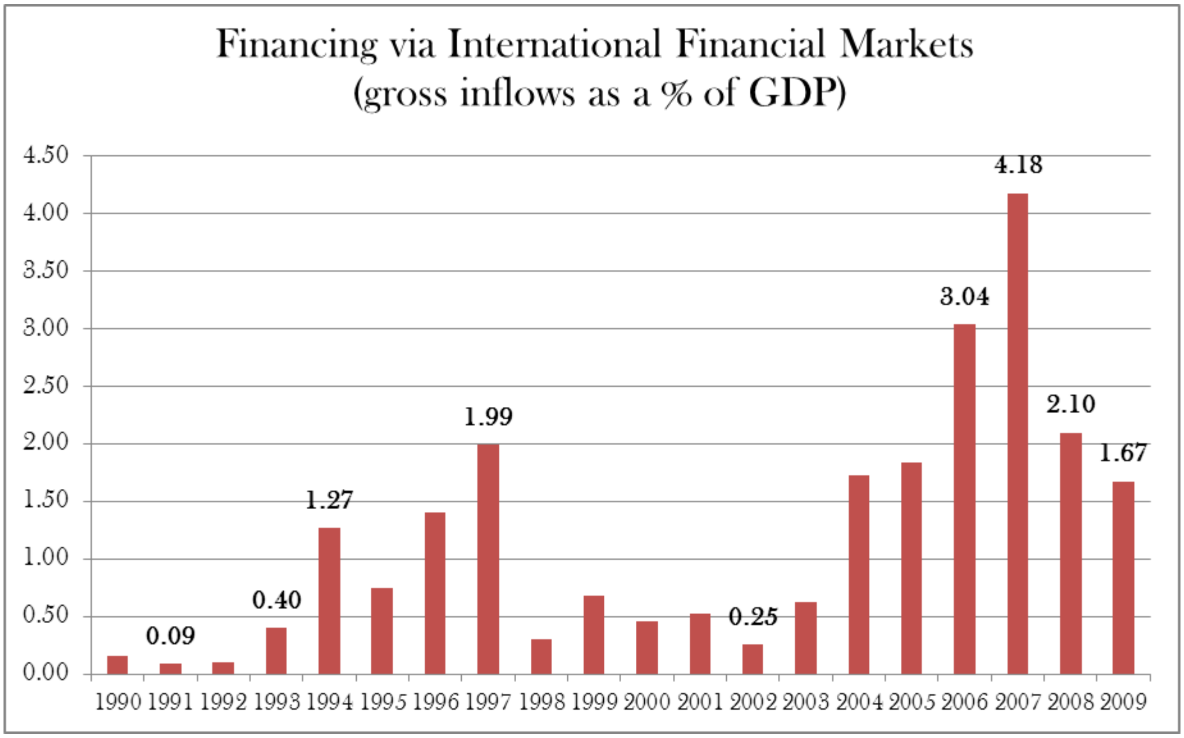
Reforms in the stock market were accelerated by a stock market scam in 1992 that revealed serious weaknesses in the regulatory mechanism. Reforms implemented include

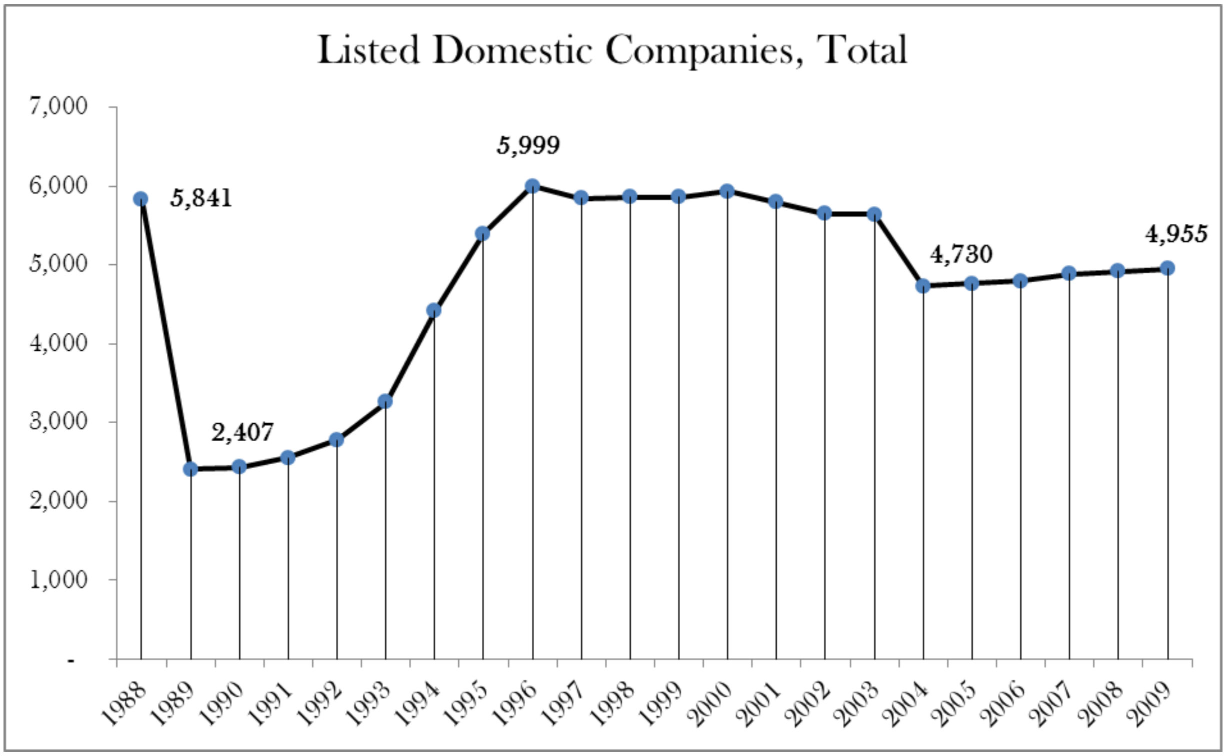
- establishment of a statutory regulator;
- promulgation of rules and regulations governing various types of participants in the capital market and also activities like insider trading and takeover bids;
- introduction of electronic trading to improve transparency in establishing prices; and
- dematerialization of shares to eliminate the need for physical movement and storage of paper securities.

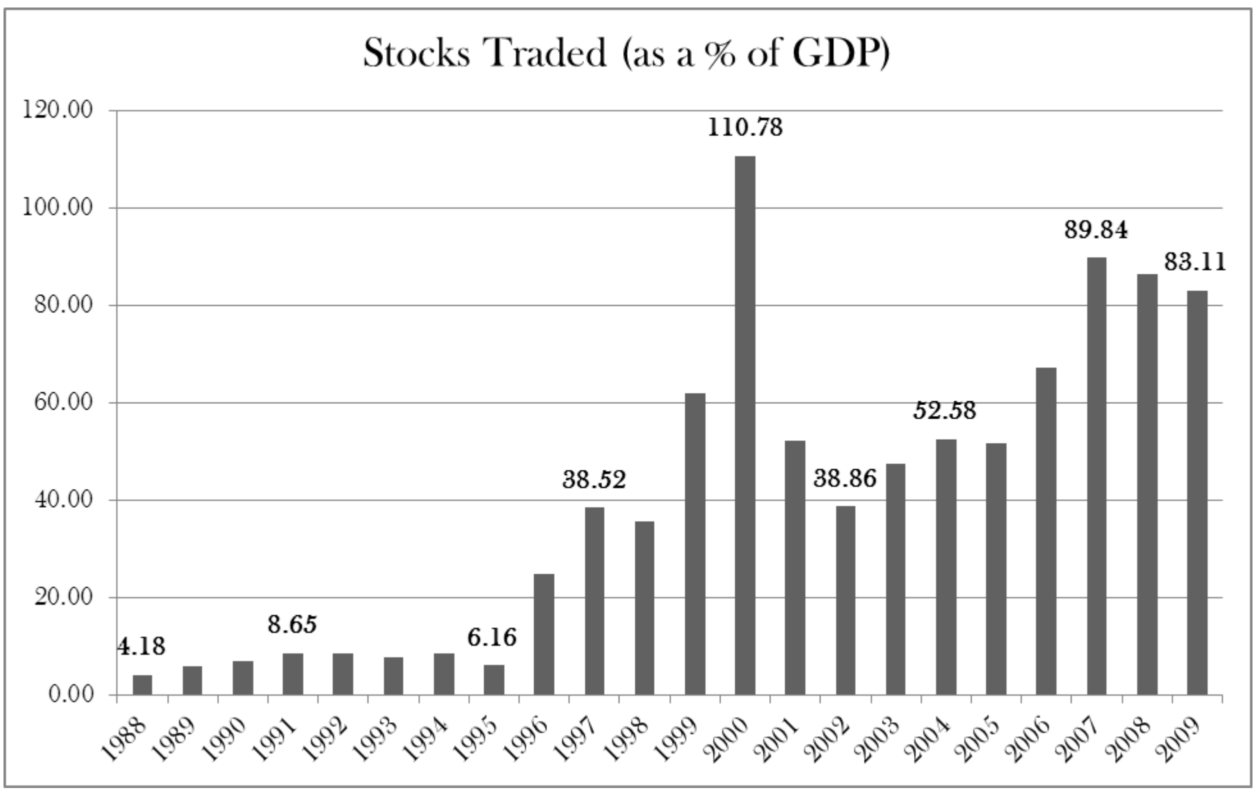
The development of institutional expertise is the prime requirement for effective regulation of stock markets. India's stock market is guided today in a much better way than it was in the past. This is reflected in the increase in foreign portfolio investments in the country since 1993, when this avenue for investment was opened.

The insurance sector was a public sector monopoly at the start of the reforms. The need to open the sector to private insurance companies was recommended by an expert committee (the Malhotra Committee) in 1994, but it met with strong political resistance. It was only in 2000 that the law was fully amended, to allow private sector insurance companies, with foreign equity allowed up to 26%, to enter the field. An independent Insurance Development and Regulatory Authority has now been established.




Financing via International Financial Markets
(gross inflows as a % of GDP)
4.50
4.00
3.50
3.00
2.50
2.00
1.50
1.00
0.50
0.00
0.09
0.40
1.27
1.99
0.25
3.04
4.18
2.10
1.67
1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009


Listed Domestic Companies, Total
7,000
6,000
5,000
4,000
3,000
2,000
1,000
-
5,841
2,407
5,999
4,730
4,955
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009


Stocks Traded (as a % of GDP)
120.00
100.00
80.00
60.00
40.00
20.00
0.00
4.18
8.65
6.16
38.52
110.78
38.86
52.58
89.84
83.11
1988
1989
1990
1991
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1993
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1995
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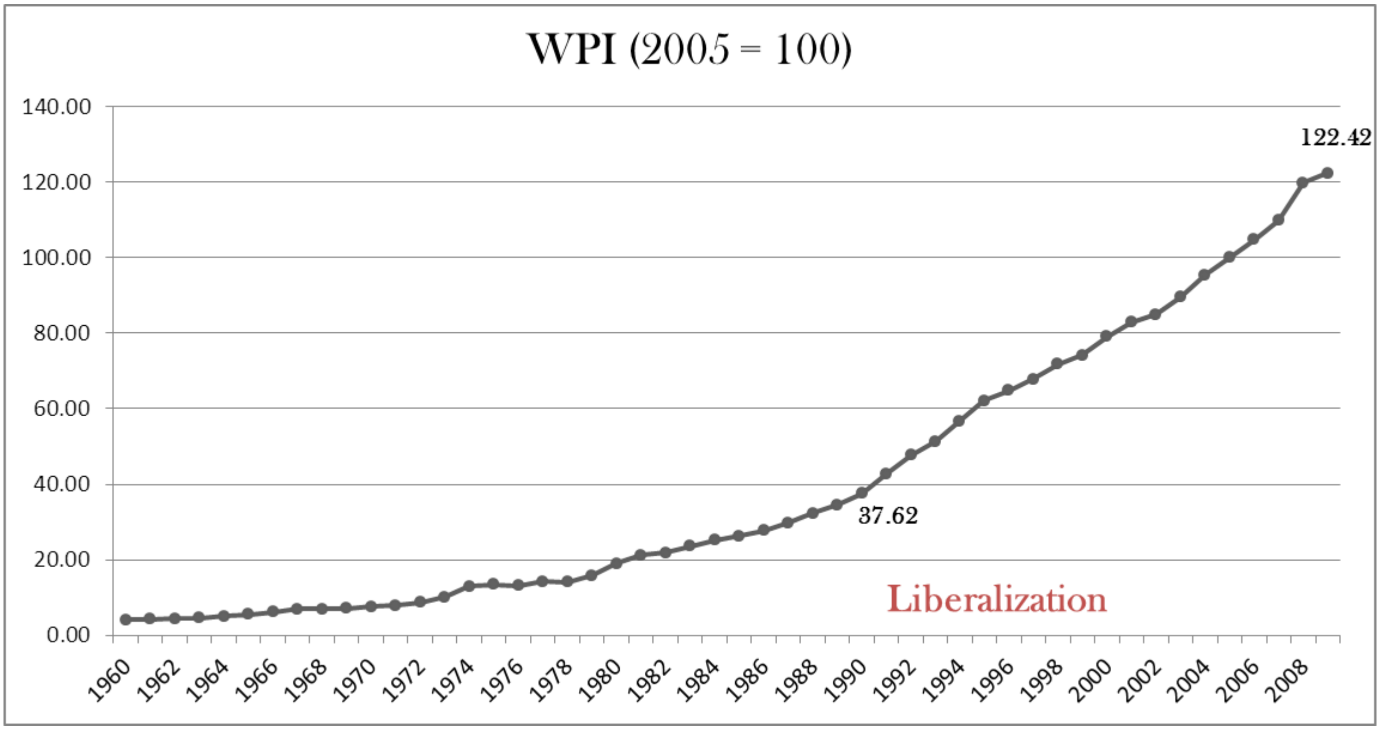
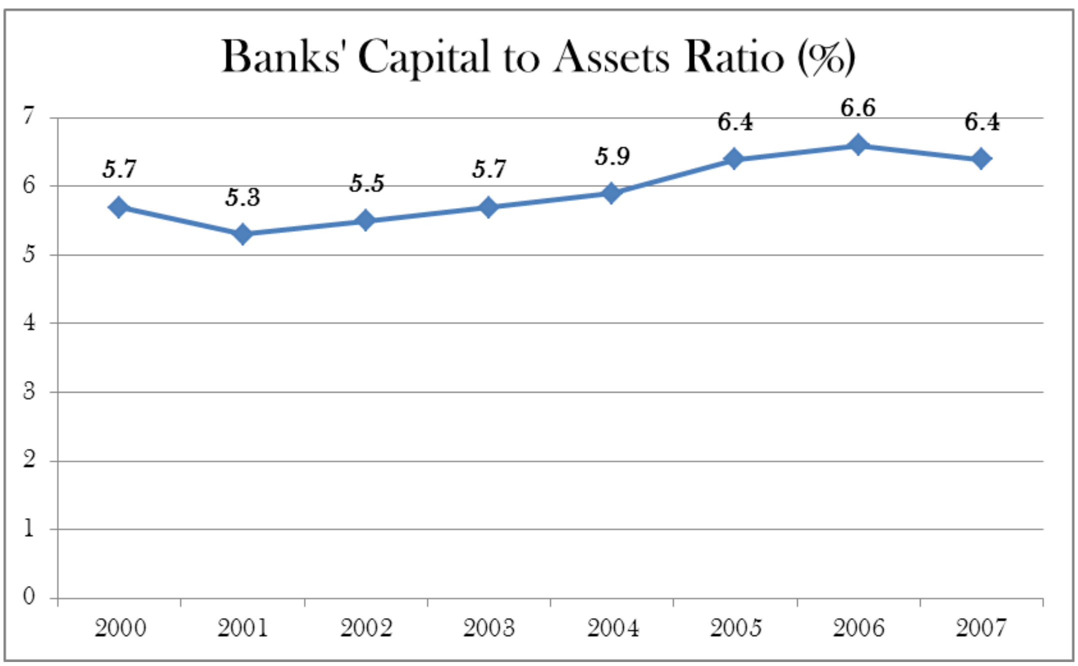
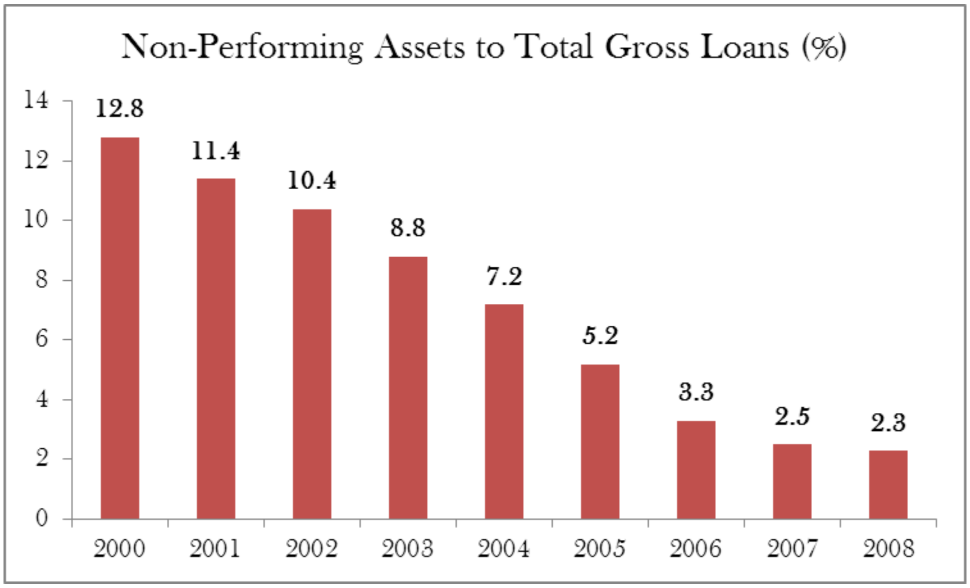
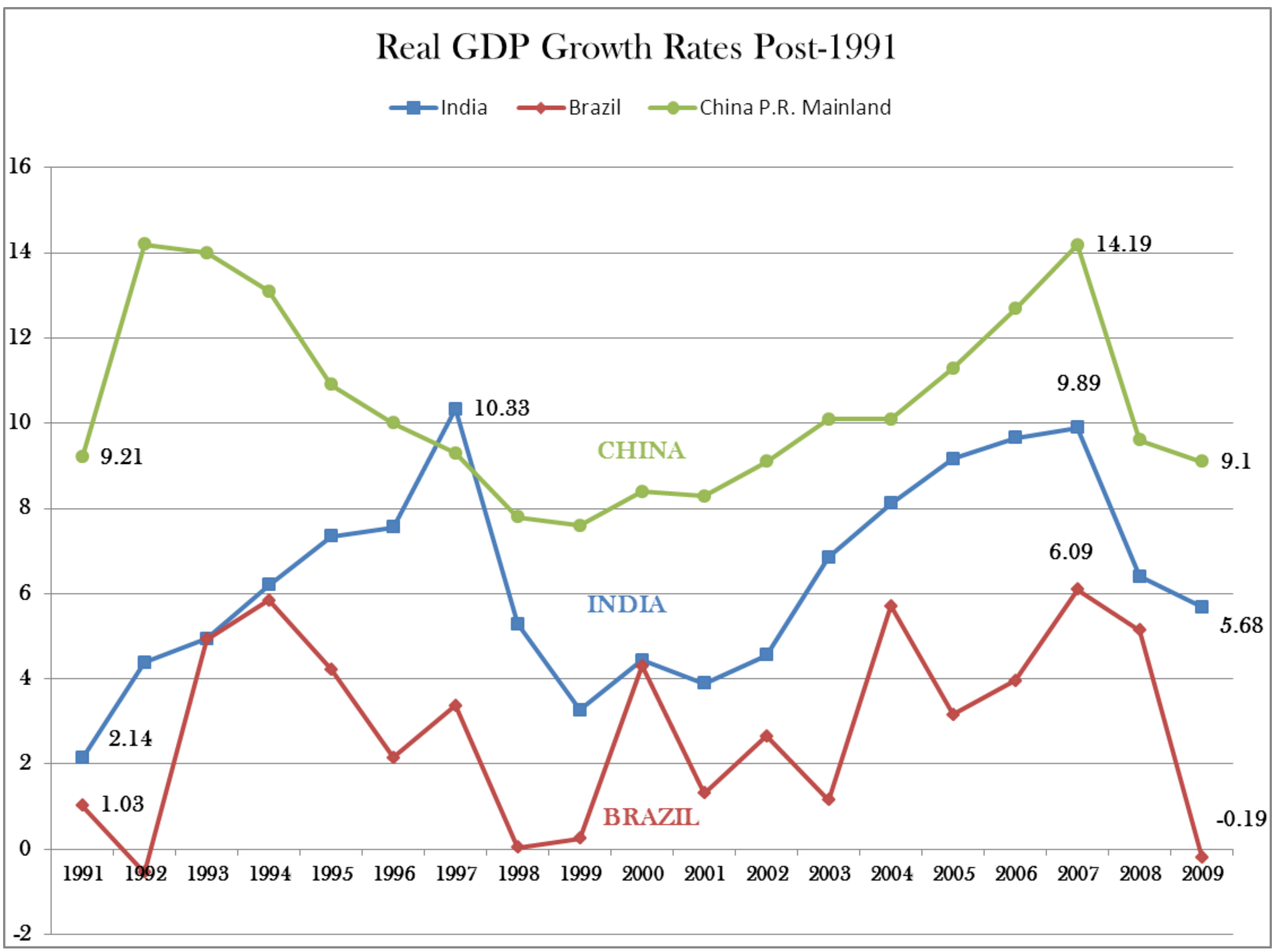
2005
2006
2007
2008
2009


WPI (2005 = 100)
140.00
120.00
100.00
80.00
60.00
40.00
20.00
0.00
122.42
37.62
Liberalization
1960 1962 1964 1966 1968 1970 1972 1974 1976 1978 1980 1982 1984 1986 1988 1990 1992 1994 1996 1998 2000 2002 2004 2006 2008


Banks' Capital to Assets Ratio (%)
7
6
5
4
3
2
1
0
5.7
5.3
5.5
5.7
5.9
6.4
6.6
6.4
2000 2001 2002 2003 2004 2005 2006 2007


Non-Performing Assets to Total Gross Loans (%)
14
12
10
8
6
4
2
0
12.8
11.4
10.4
8.8
7.2
5.2
3.3
2.5
2.3
2000
2001
2002
2003
2004
2005
2006
2007
2008


Real GDP Growth Rates Post-1991
India
Brazil
China P.R. Mainland
16
14
12
10
8
6
4
2
0
-2
14.19
9.89
10.33
CHINA
9.21
9.1
6.09
INDIA
5.68
2.14
1.03
BRAZIL
-0.19
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009

Infrastructure Reform in India:

1947-1991 Pre-Liberalisation	1991 Liberalisation	1991 – till date Post-Liberalisation
• Government sponsored • Focus on creation of basic utilities • Benefits restricted • Lagging behind global Standards • Infrastructure spending : 3% of GDP	• Public private partnerships • Framework created for building basic infrastructure • Landmark projects rolled - The Pillars • Strive towards global benchmarks • Infrastructure spending : 4% of GDP	• Further reforms within established framework • Move towards utilization of basic infrastructure • Secondary & tertiary projects - The cascading effect • Perceptible benefits to the economy & percolating down • Infrastructure spending : 5% of GDP
- to accelerate infrastructure spending to sustain GDP growth at 8 % plus		

Power

- Sixth largest energy consumer in the world
- Installed capacity of 145,587 MW
- Demand-Supply gap of 100,000 MW
- Setting up of merchant power plants encouraged
- Franchisee model favored for electricity distribution
- 100% FDI allowed for generation, transmission & distribution

Unbundling, liberalization and privatization: Key to success

Roads

- Second largest road network - 3.34 million km
- 7-phase plan for upgrading & modernizing over 33,000 km route length of national highways
- 310,000 km of rural roads being developed
- All contracts awarded through competitive bidding
- 100% FDI allowed in road projects

PPP and sustained state initiatives brought about world class road network

Telecom

- World's fastest growing telecom market
- Telecom subscription at over 500 million, teledensity at 43.5%
- Next wave of telecom growth to come from rural markets

- Telecom towers : Needed 400,000 vis-à-vis present 200,000
- Up to 74% FDI allowed for telecom service providers
- 100% FDI allowed for telecom equipment manufacturers

Entrepreneurship and a proactive regulator- a potent recipe

Railways

- World's second largest rail network - 63,140 route km
- Carrying 14 million passengers daily
- Over a million tonne of freight traffic daily
- Plan for 10,300 km of new railway lines
- Plan for gauge conversion of over 10,000 km
- PPP opportunities :
  - Logistic parks
  - Warehouses
  - Budget hotels
  - Wagon leasing schemes

CONCLUSION:

What remains to be asked is - Have the reforms laid the basis for India to grow at 9% per year? Is it safe to be optimistic since the cumulative change brought about is substantial?

The reforms have been through a slow pace of implementation which means that many of the reform initiatives have been put in place recently and their benefits are yet to be felt. If the critical links are put in place, the policy environment today is much more supportive.