

# India's Economic Growth and Global Integration: Experience since Reforms and Future Challenges

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It is well-known that India's development strategy since 1950, until the systemic reforms after 1991 and some hesitant piecemeal reform in the mid-1980s, was articulated through five-year and annual plans put together by the Planning Commission.

Although a large share of gross domestic product (GDP) and an even larger share of employment were generated by the private sector, the state played a dominant role in three ways: first, by emphasizing import substitution across the board and industrialization as core strategies; second, by appropriating a large share of the savings of the economy for its own use, largely for public investment until the '80s and also for public consumption thereafter; and third, by attempting to steer the private sector to conform to the priorities and targets set in the plans through various instruments of controls, many of which were in the form of quantitative restrictions rather than taxes and subsidies. Moreover, most of the instruments of control were exercised on a discretionary, case-by-case basis, rather than through a set of rules, and, in effect, insulated producers from domestic and international competition.

At its most expansive and inclusive, the system involved the following: *industrial licensing*, under which the scale, technology, and location

of any investment project other than relatively small ones were regulated, and permission from the government was needed to expand, relocate, and change the output or input mixes of operating plants; the *exchange control system*, which required exporters to surrender their foreign exchange earnings to the Reserve Bank of India at the official exchange rate and allocated the exchange earnings to users through *import licensing*; *capital issues control*, under which access to domestic equity markets and debt finance was controlled; *price controls* (complete or partial) on some vital consumption goods (for example, foodgrains, sugar, vegetable oils) and critical inputs (for example, fertilizer, irrigation water, fuel); and *made-to-measure* protection from import competition, granted to domestic producers in many “priority” industries, including in particular the equipment producers.

The agricultural sector was insulated from world markets, subjected to land ceiling and tenancy legislation, and forced to sell part of the output at fixed prices, but it was also provided subsidies on irrigation, fertilizer, and electricity. Large commercial banks, which were nationalized in 1969, were subject to directed and selective credit controls, as well as controls on deposit and lending rates. They, in effect, had to lend more than half of their loanable funds to the government through the operation of reserve requirements of various kinds.

The controls taken together were far more restrictive than each of them individually. For example, the granting of an industrial license did not imply the granting of a capital goods import license so that the capacity licensed could not be operational if the intended imports were essential. Besides the crucial aspect of all the regulations is the uncertainty about their fair implementation because they were essentially *discretionary* rather than *rule-based* and *automatic*. Although some principles and priorities were to govern the exercise of these regulatory powers, these were largely nonoperational for two reasons. First, it was impossible, even in theory, to devise a set of principles or rules for the myriad of regulation categories that were mutually consistent and in consonance with the industrial policy framework’s multiple goals, which in themselves were not entirely consistent. Second, the problem of translating whatever rules there were into

operational decisions was one of Orwellian dimensions. The allocative mechanism was largely in the form of quantitative restrictions unrelated to market realities. A chaotic incentive structure and the unleashing of rapacious rent-seeking and political corruption were the inevitable outcomes. Indeed, the discretionary regulatory system instituted in the name of planning for national development instead became a cancer in the body politic.

Another dimension of the exercise of regulatory power was that it was *anticipatory* in nature—that is, the regulations were meant to *prevent* the occurrence of any prospective deviation from the objectives of policy by firms or other regulated entities rather than to *punish* or cure any deviant behavior that actually occurred. While preventive, rather than curative, medicine is often preferable in health-care systems, clearly it is not appropriate in industrial regulations. But in India, a system of *curative* health care and *preventative* industrial regulations has been in existence since the 1950s.

Three decades of planning, state controls, and insulation delivered an average growth rate of real GDP 3.75 percent per year during 1950-1980. I do not wish to delve deeply into the political economy of India's development strategy prior to reforms except to say that at the time of independence, there was a consensus across the political spectrum on planning for development, on the dominant role for the state, and for insulation from world markets. As a massive balance of payments crisis emerged in 1966, the second five-year plan with large investment in heavy industry was about to end and there were two successive dry monsoon seasons that led to severe droughts in 1965 and 1966 and the need for large imports of food.

At that time, India was heavily dependent of concessional food imports from the United States under Public Law 480 (PL 480). Although PL 480 food aid continued throughout 1965 and 1966 with aid in the pipeline not halted and two new loan agreements between India and the United States in October 1965 and June 1966, fresh commitments were held up. It is alleged that President Johnson wanted to keep India on a short leash and approved food aid on a

shipment-by-shipment basis to express his displeasure with India's opposition to the Vietnam conflict. Moreover, external aid to India (and Pakistan) had been suspended following the Indo-Pakistani War of 1965.

India approached the World Bank and International Monetary Fund (IMF) for assistance to deal with the crisis. Predictably, the conditionalities for assistance included devaluation of the rupee, economic liberalization, and agricultural policy reform, an agenda that the World Bank had been pressing earlier with the strong urging and support of its dominant shareholder, the United States. The Bank also promised a significant amount of nonprofit assistance to support its reform agenda and ease the burden of adjustment. The rupee was devalued and liberalization of import and other controls was announced. Agricultural policies in the form of price supports and input subsidies followed later in support of the green revolution. It so happened that the World Bank reneged on its promised assistance because of U.S. opposition.

Largely because of opposition to reform within the then-newly installed Prime Minister Gandhi's own party, the loss of seats in Parliament in the 1967 general elections (widely perceived as a rebuke to the government for having surrendered to external pressure), and the failure of the World Bank to deliver the promised assistance, Mrs. Gandhi reversed liberalization measures in 1968 and, in fact, intensified them later on as part of her efforts to consolidate power. Until the early '80s, a few years before her assassination, she would not contemplate the dismantling of controls. Her son, Rajiv Gandhi, who succeeded her and won a huge majority in Parliament, though he wished to move the economy in a different direction, did not succeed in doing so, again because of lack of support in his own party. Interestingly, East Asian countries which broke away from inward orientation and adopted outward orientation did so in the mid-1960s. Had Mrs. Gandhi not reversed India's opening and intensified it instead, in my view, India would have replicated East Asian growth.

The intensification of controls as well as government interventions in agriculture in support of the green revolution through various

subsidies and price supports created vested interests in their perpetuation as a system, while at the same time asking for and succeeding in getting those controls relaxed that turned out to be irksome. Although the process of relaxation of controls here, and an increase of incentives of subsidies there, went on all the time, the mid-1980s saw more of them being undertaken. These, together with the abandonment of fiscal prudence of three decades, with fiscal deficits financed by borrowing at home and abroad, delivered an average growth rate of around 5.5 percent per year. With the rate of population growth having declined from around 2.2 percent per year during 1950-1980 to 2 percent per year during 1980-1990, rate of growth of per capita real GDP doubled in the '80s as compared to 1950-1980. However, this growth was unsustainable, as it was Latin-style, debt-led growth. It ended in a macroeconomic and balance of payments crisis in 1991 as the First Gulf War broke out and oil prices went through the roof. At the height of the crisis, foreign reserves were down to less than two weeks worth of imports, and short-term external debt was several times the level of reserves.

It is no surprise that India went to the World Bank and IMF again as in 1966. The conditionalities for their assistance were also the same as before: devaluation and liberalization. What was different this time was that the government initiated a set of systemic reforms that went beyond the conditionalities by eliminating investment and import licensing, unifying the exchange rate, undertaking a series of financial sector reforms, and actively seeking foreign direct investment rather than inhibiting it as earlier. The economy responded well—the rate of growth GDP rebounded from 1.5 percent in the crisis of 1991-1992 to reach a peak of 7.8 percent in 1996-1997. Subsequently, the growth rate fluctuated, though in the three years ending in 2005-2006, it has averaged 8 percent a year.

In my view, there were basically two reasons that systemic reforms were undertaken after the 1991 crisis rather than a return to status quo as happened after 1966: the collapse of the Soviet Union and its planned economy, on which Indian planning was modeled, and the rapid growth of China since its opening in 1978. Having fought and

lost a boundary war with China in 1962, India could not afford to be left behind by China. It is also the case that many in India, in government, politics, business, media, and the street, view China as India's only relevant economic rival and comparator. The outside world also has come to recognize the likely impact the rapid growth in the two giants will have on it. My background paper is addressed to the growth of the two giants and its global impact.

It is clear that compared to the debt-led growth of the '80s, the post-1991 growth is less likely to be unsustainable. However, India faces a number of challenges if the recent growth of 8 percent per year is to be sustained and accelerated in the next couple of decades. An acceleration to 10 percent or faster is needed if India's poverty is to be eradicated once and for all. I will conclude with mentioning some of them.

First, in spite of more than 15 years of attempts to integrate India with the global economy, India's share in global merchandise exports rose from a measly 0.5 percent in 1983 to only 0.8 percent in 2004. During the same period, China's share grew more than fivefold to 6.7 percent from 1.2 percent. As a share of GDP, exports and imports accounted for 31 percent for India in 2004, as contrasted to 65 percent for China. India has still some way to go from being one of the most protected developing countries, as it is now, to a truly open economy. But there are no insurmountable constraints to opening the economy further.

Second, the shares of China and India in global GDP and their growth have been increasing: India's share in global GDP 2004 at 1.67 percent (at 4.14 percent growth in 2000-2004) was much lower than China's at 4.68 percent (17.60 percent), reflecting, of course, China's faster growth at around 9 percent per year compared to India's 6 percent since 1980. India is still a very modest player in the global economic scene, though its impact is increasing.

Third, turning to sources of growth, India's saving and investment rates were around 30 percent of GDP in 2004-2005, and China's, exceeded 40 percent. Demographic trends are different in the two

countries. China's working-age population is projected to fall from more than two-thirds of the total population in 2005 to around half in 2050, and its dependency rate is projected to rise from around 60 percent to 90 percent during the same period. In India, the share of the working age is projected to remain at 60 percent, and the dependency ratio is projected to fall slightly from two-thirds during the same period. Moreover, India has a much larger share of working population in low-productivity primary activities. Taken together, the demographic trends and life-cycle considerations would point first to a rise in savings rates in India and a fall in China. If India, with lower literacy and educational attainments than China, catches up, the contribution of human capital to growth would be higher than China's. While in China the intersectoral shift of labor from low-productivity activities will only attenuate the lower rate of growth of labor inputs, in India, the rate of growth of labor inputs will increase and will be augmented by intersectoral shifts.

Turning to total factor productivity (TFP) growth, although in both countries the move away from insulation and dirigisme seems to have improved TFP growth, the available range of estimates do not suggest a distinct advantage for one country over the other, with both likely to experience a TFP growth of 2.5 percent to 3.1 percent per year in the future. In summation, India's growth rate is likely to accelerate and be sustained in the 8 percent to 10 percent range, while China's will remain at around 10 percent a year.

Fourth, China received \$74 billion in private capital flows in 2004, of which \$55 billion was foreign direct investment (FDI). The corresponding figures for India were \$19 billion and \$5 billion, respectively. A number of factors relating to the poorer investment climate in India explain this difference. India is only now creating Special Economic Zones (SEZs). China created them in the early '80s, gave investors in the zones freedom to hire and fire as they pleased, and provided excellent infrastructure. Full foreign ownership was allowed. Much FDI, particularly by overseas Chinese, made China an export platform for labor-intensive manufacturers. India

has not relaxed its draconian labor laws in SEZs, and various sectoral caps apply to FDI. Infrastructure, particularly power, is a continuing bottleneck in India. It is very unlikely that India would be able to replicate the success of Chinese SEZs.

Fifth, although there are some encouraging signs that India will be able to attract offshoring of manufacturers such as auto parts, India's manufacturing sector as a whole has not been a fast-growing sector. Share of manufacturing in India's GDP is still less than 20 percent, far below China's. While China has been able to increase its share of the textiles and apparel market in Europe and North America as the Multifiber Arrangement quotas were being phased out, India's share went up only modestly. In India, the reservation of the production of apparel for small-scale industries was removed only recently. There are still many exportable labor-intensive manufacturers that are reserved for the small-scale sector. The restrictions of labor laws and archaic, time-consuming, and costly bankruptcy procedures have affected entry and exit. Unless reforms in all these areas are undertaken, it is unlikely that a substantial acceleration of growth of manufacturing will come about.

Sixth, the service sector exports, particularly by software and business process outsourcing and other IT-enabled services, have grown very rapidly in India. However, even with its phenomenal growth, India cannot leap-frog the manufacturing stage of the development process in shifting labor from agriculture and primary activities to more productive occupations.

Seventh, although India has a comparative advantage in agriculture and the export potential of high-value crops, including horticulture, is huge, infrastructural bottlenecks and institutional rigidities relating to land use severely limit the possibilities of rapidly expanding agricultural exports.

Eighth, India's gross fiscal deficit continues to be high. Although the deficit had been brought down significantly from its level of 9.4 percent of GDP in 1990-1991 to 6.5 percent in the first five years of reform, it began increasing thereafter. It was estimated at 7.7 percent of GDP in 2005-2006 and budgeted at 6.5 percent for 2006-2007.



The overall debt of the government was 80 percent of GDP in 2005-2006. These indicators are disquieting. Unless the fiscal situation is addressed soon, the prospects of making the rupee fully convertible and sustaining a growth rate of 8 percent will be compromised.

Finally, a bright spot: India's financial sector after reforms is much better than China's. In conclusion, let me say that India has several institutional advantages over China: a thriving representative democracy, a well-developed private sector and financial system, a relatively entrenched legal system, and modestly better governance. Several bottlenecks I mentioned are not insurmountable: With a deepening, a widening, and an acceleration of the reform process, they can be surmounted. This, in turn, means that India with China could fuel global economic growth.