

INDIAN ECONOMY

GROWTH AND ECONOMIC
REFORMS

FOUR PHASES OF
ECONOMIC DEVELOPMENT

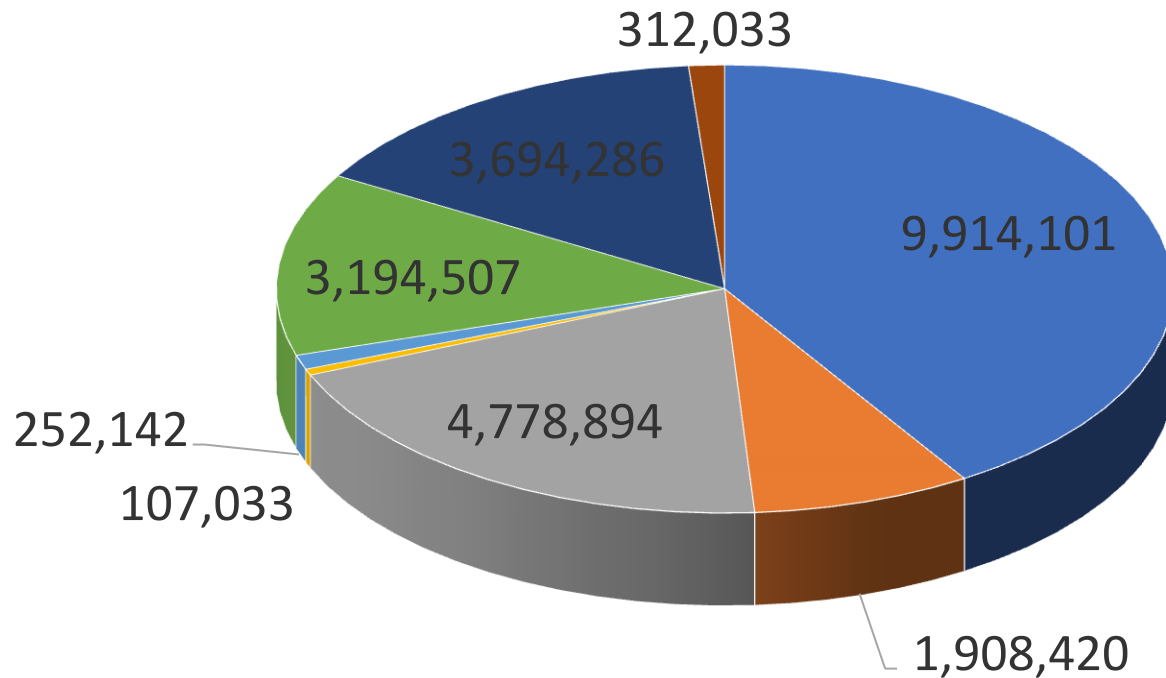
Agenda

- Gross Domestic Product – the most important number in Economics
- A brief history of world's economic growth
- India's economic growth
 - Phase – I : 1950-1965 : The Nehru Era –take off under a liberal regime
 - Phase – II: 1966-1980 : Socialism strikes with a vengeance
 - Phase – III: 1980-1991: Reforms by stealth
 - Phase – IV and V: 1991 -2017: rapid growth and discontents
- Summary: Can India become a high income country by 2040?

What is GDP?



2017-18 GDP (current prices) -167,73,145 Cr US \$ 2,487 billions



■ PFCE

■ CIS

■ Import of goods and services

■ GFCE

■ Valuables

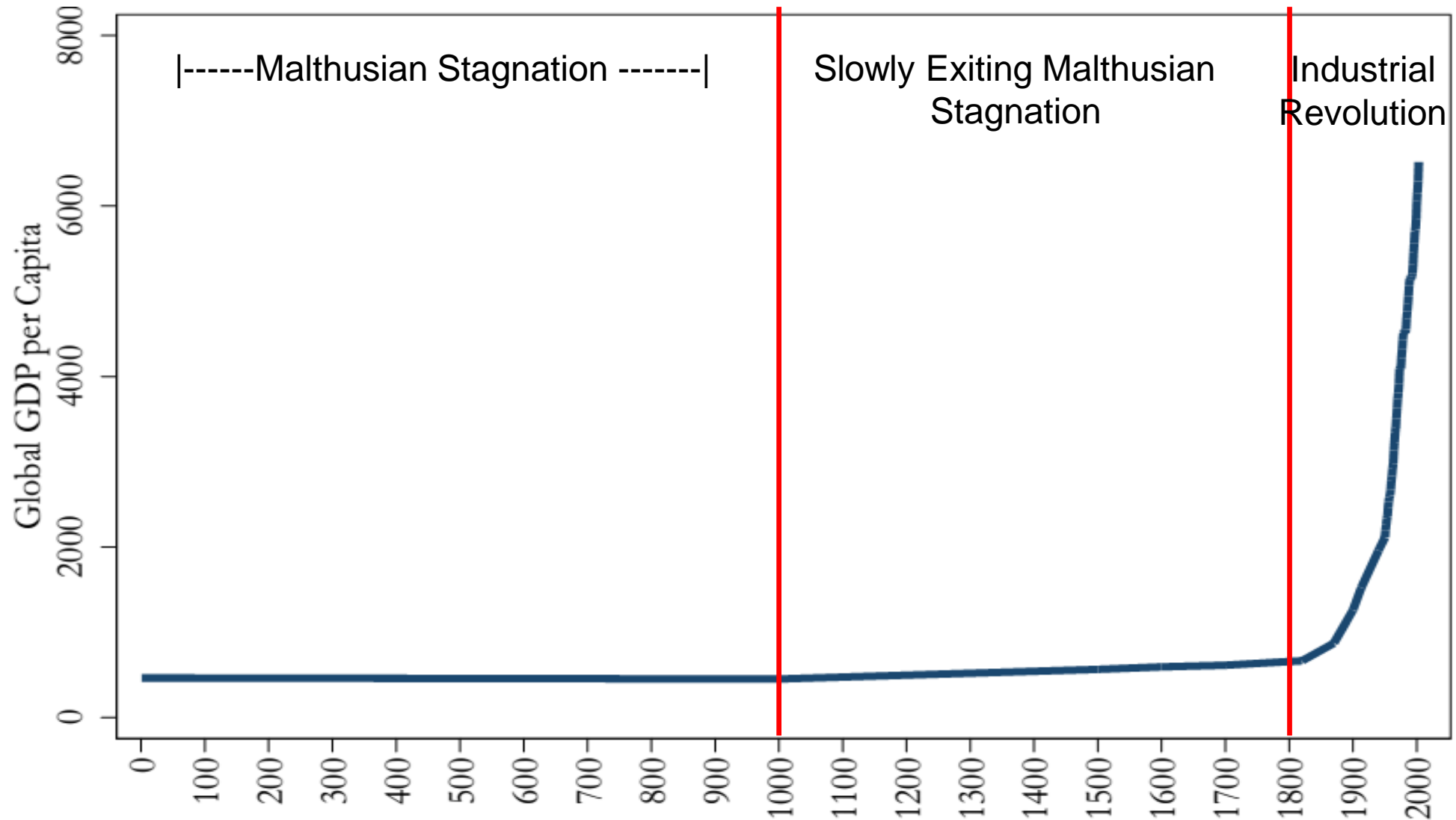
■ Discrepancies

■ GFCF

■ Export of goods and services

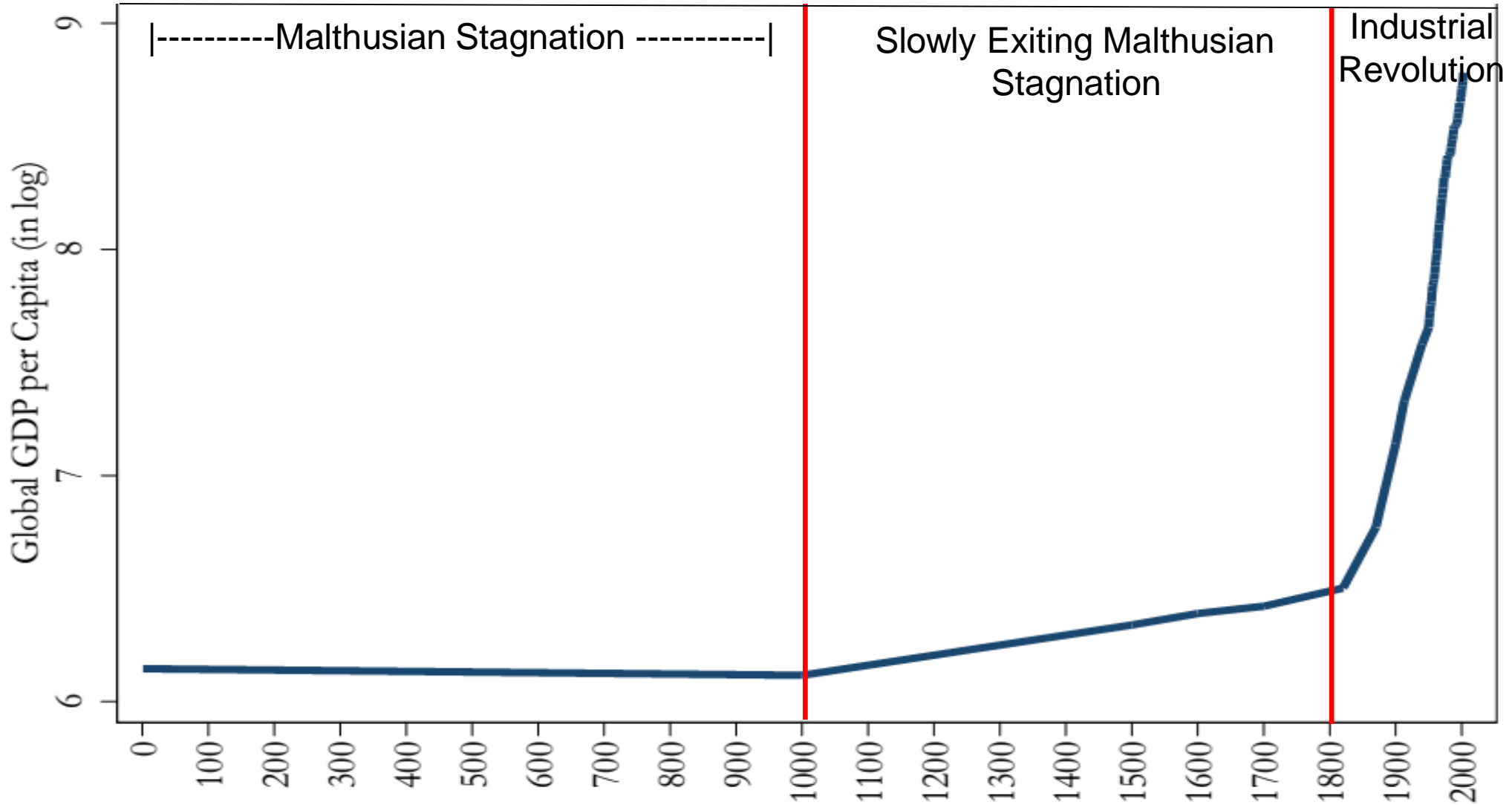
<http://www.mospi.gov.in/#>

World History in One Slide



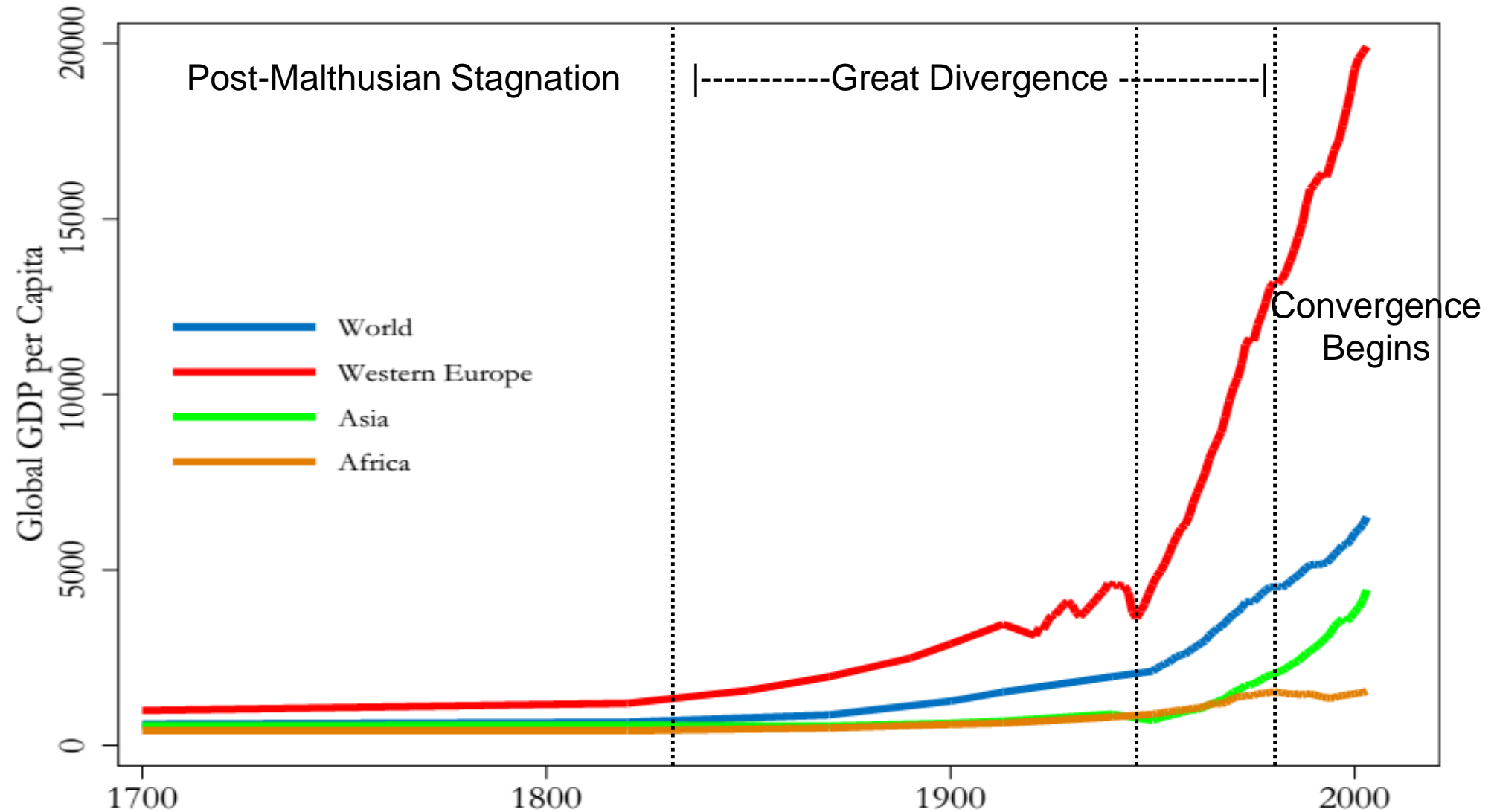
Source: Maddison Historical Series, World Development Indicator and Own Calculation

Cont...(World History in One Slide)



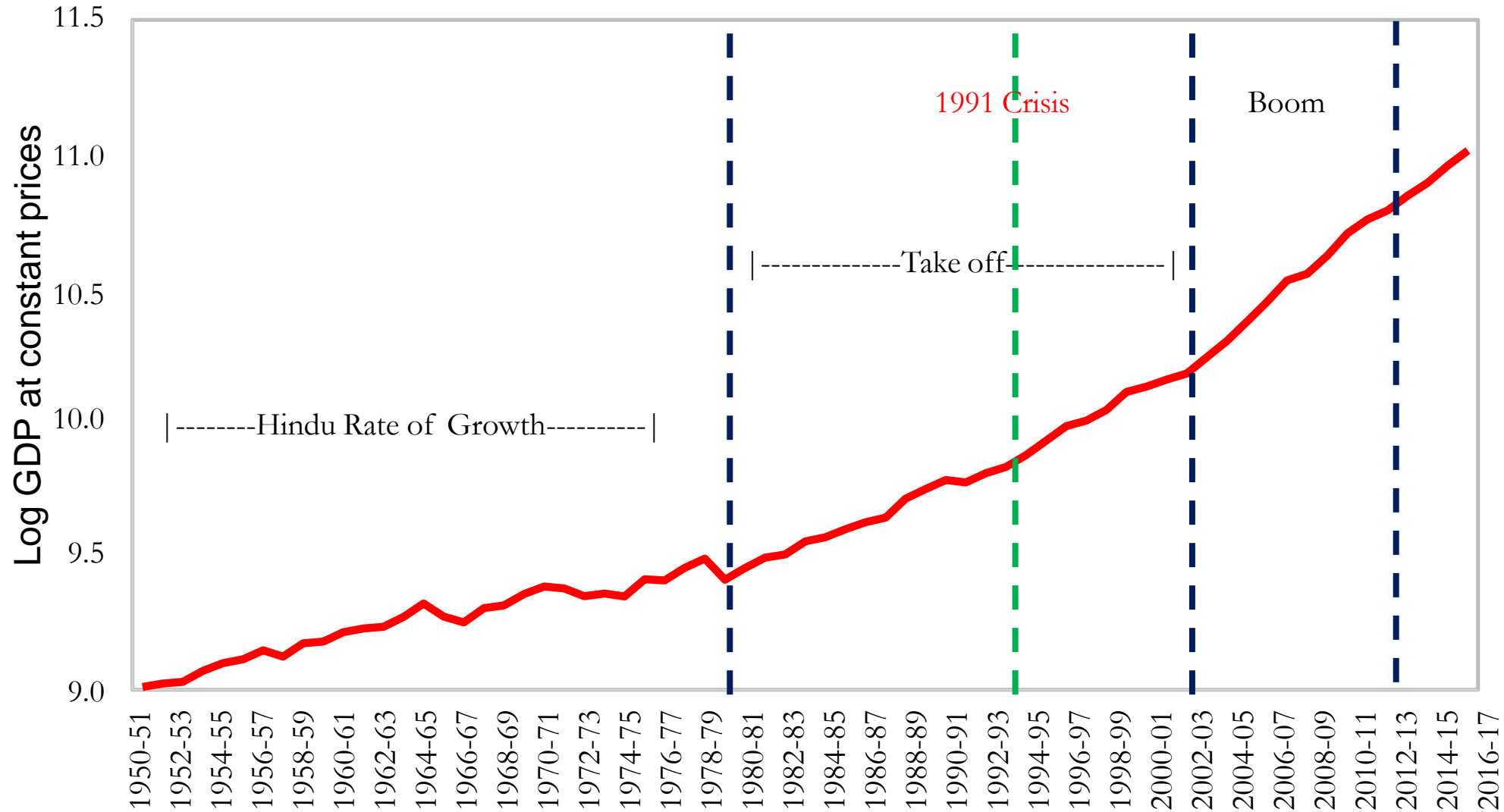
Source: Maddison Historical Series, World Development Indicator and Own Calculation

History of Different Regions in One Slide

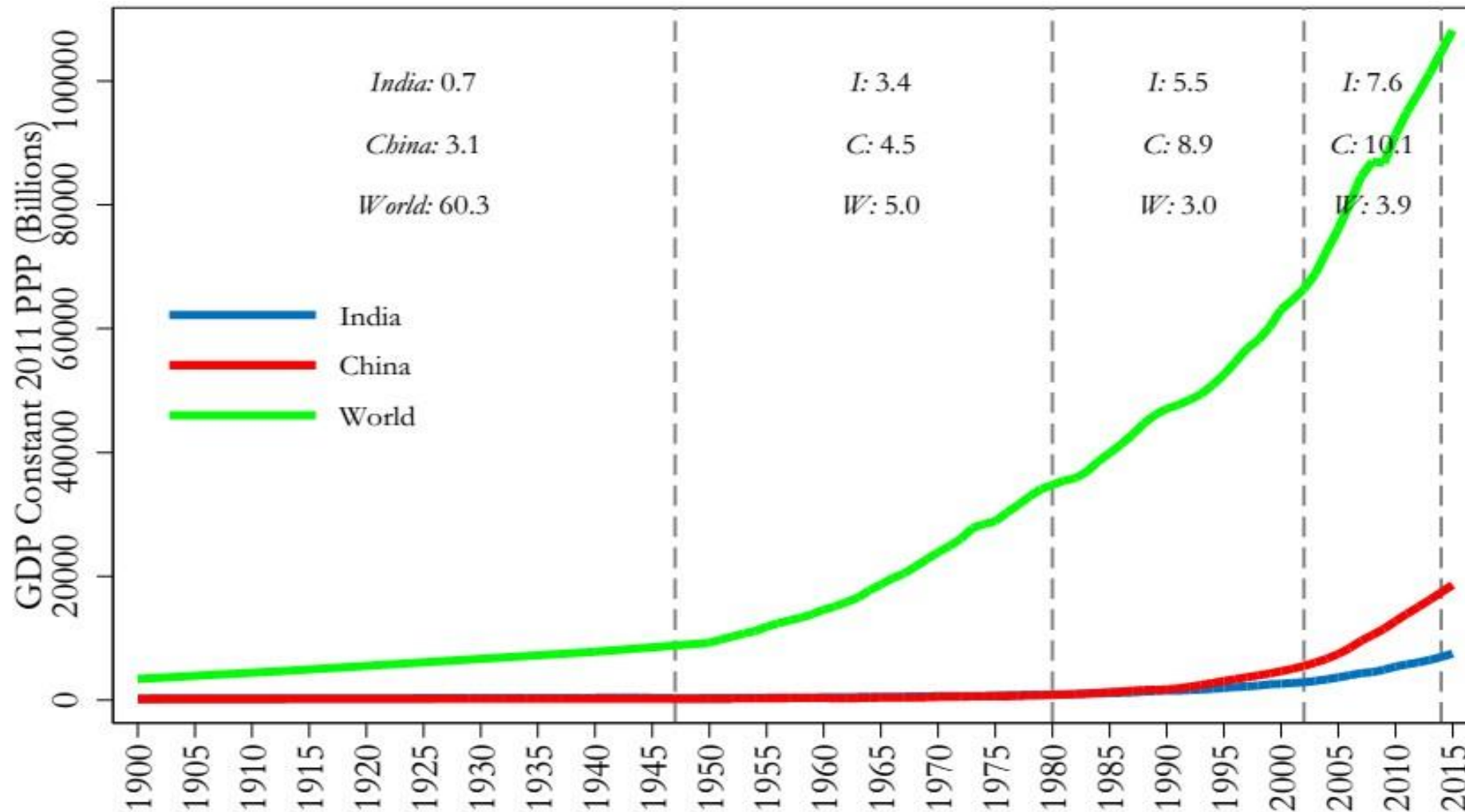


Source: Maddison Historical Series, World Development Indicator and Own Calculation

Indian Growth History: 50-50 (Hindu versus Rapid Growth)

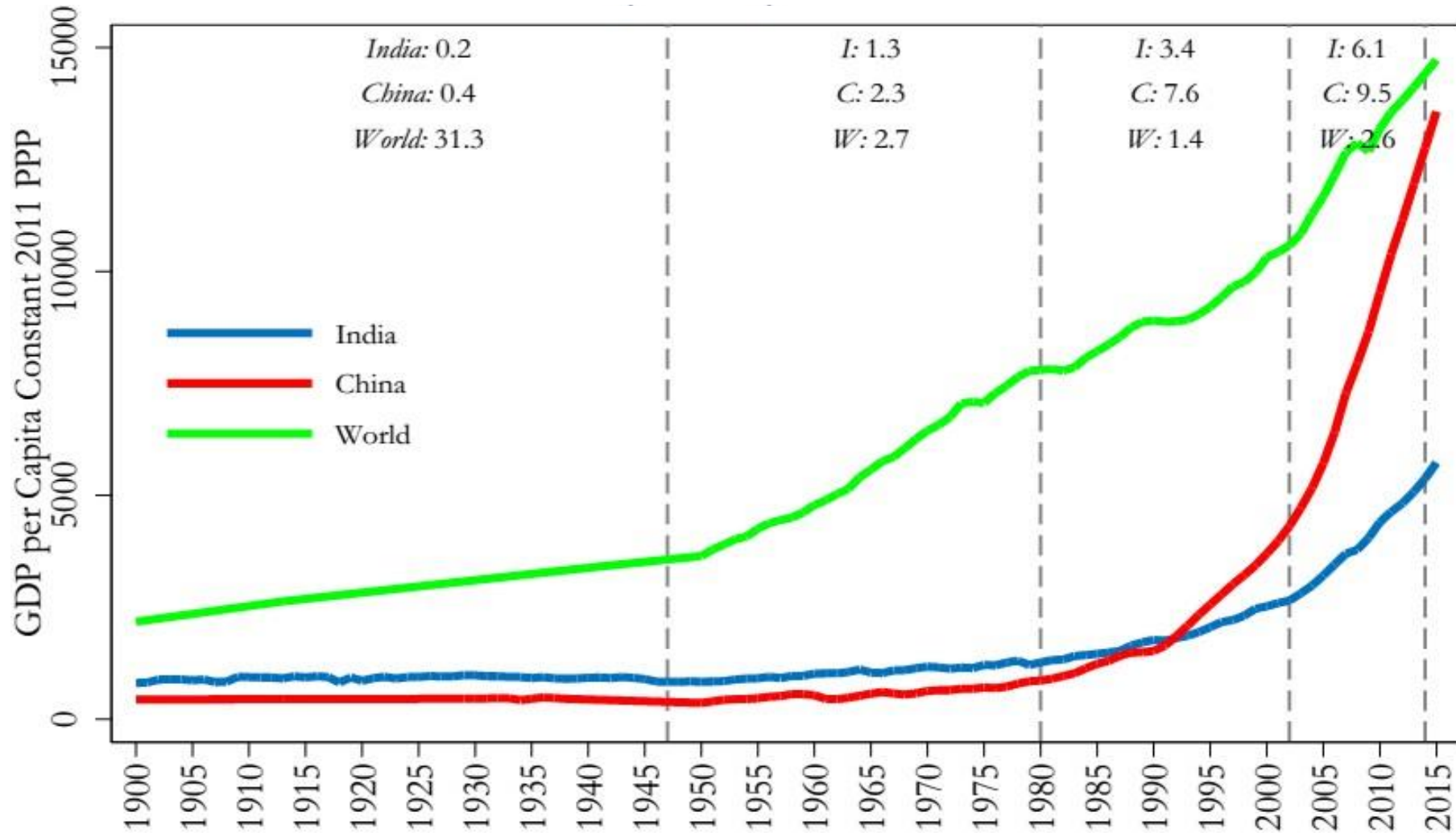


Chindia From 1900-1980



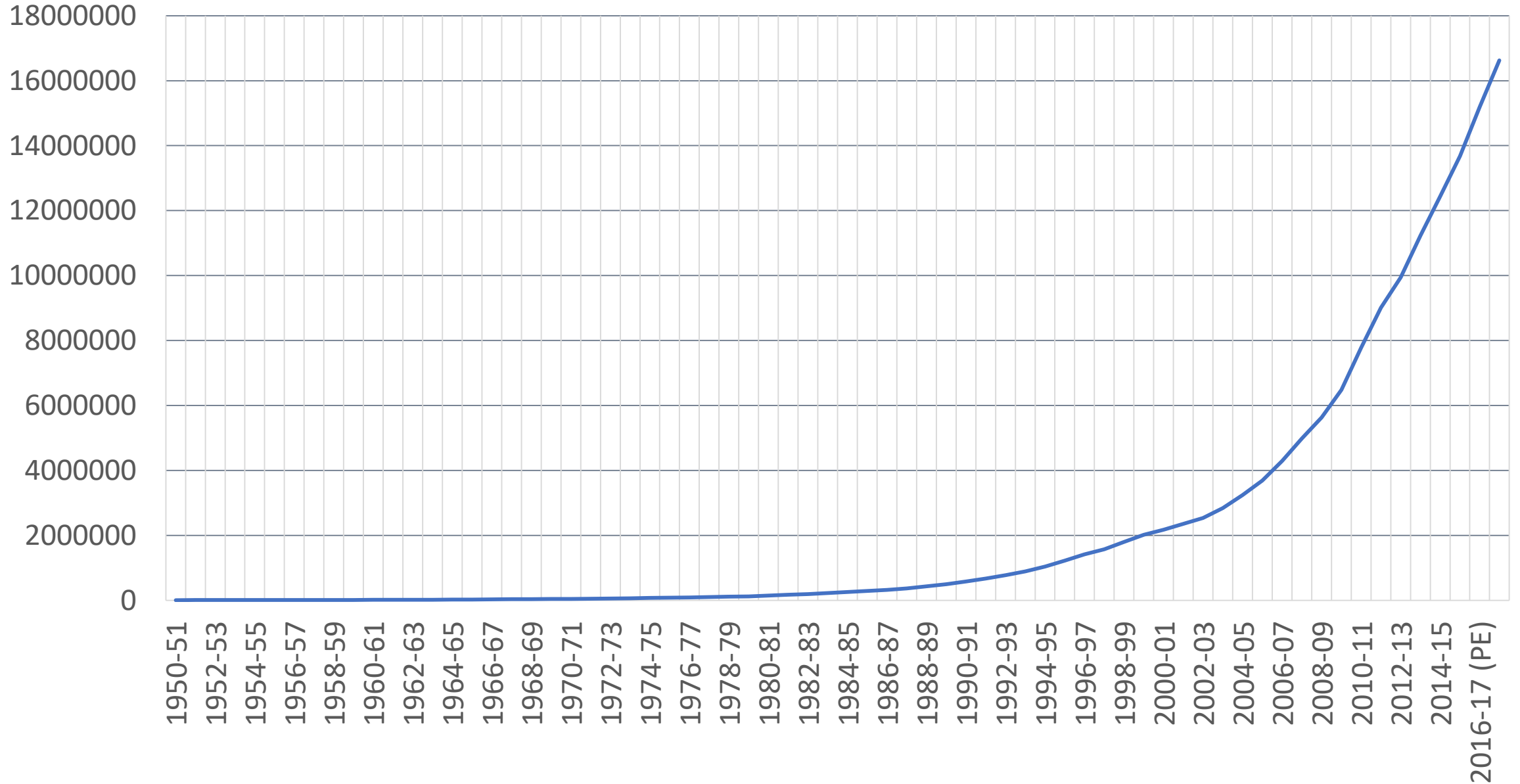
NB: Data based on Maddison historical estimates and the World Bank's World Development Indicators. Average growth rates for each period are shown.

Reversal of Fortune Between China and India



NB: Data based on Maddison historical estimates and the World Bank's World Development Indicators. Average growth rates for each period are shown.

India GDP (current in Rs Cr)



GDP (factor cost) growth rate

12.0%

10.0%

8.0%

6.0%

4.0%

2.0%

0.0%

-2.0%

-4.0%

-6.0%

Year

1952-53

1954-55

1956-57

1958-59

1960-61

1962-63

1964-65

1966-67

1968-69

1970-71

1972-73

1974-75

1976-77

1978-79

1980-81

1982-83

1984-85

1986-87

1988-89

1990-91

1992-93

1994-95

1996-97

1998-99

2000-01

2002-03

2004-05

2006-07

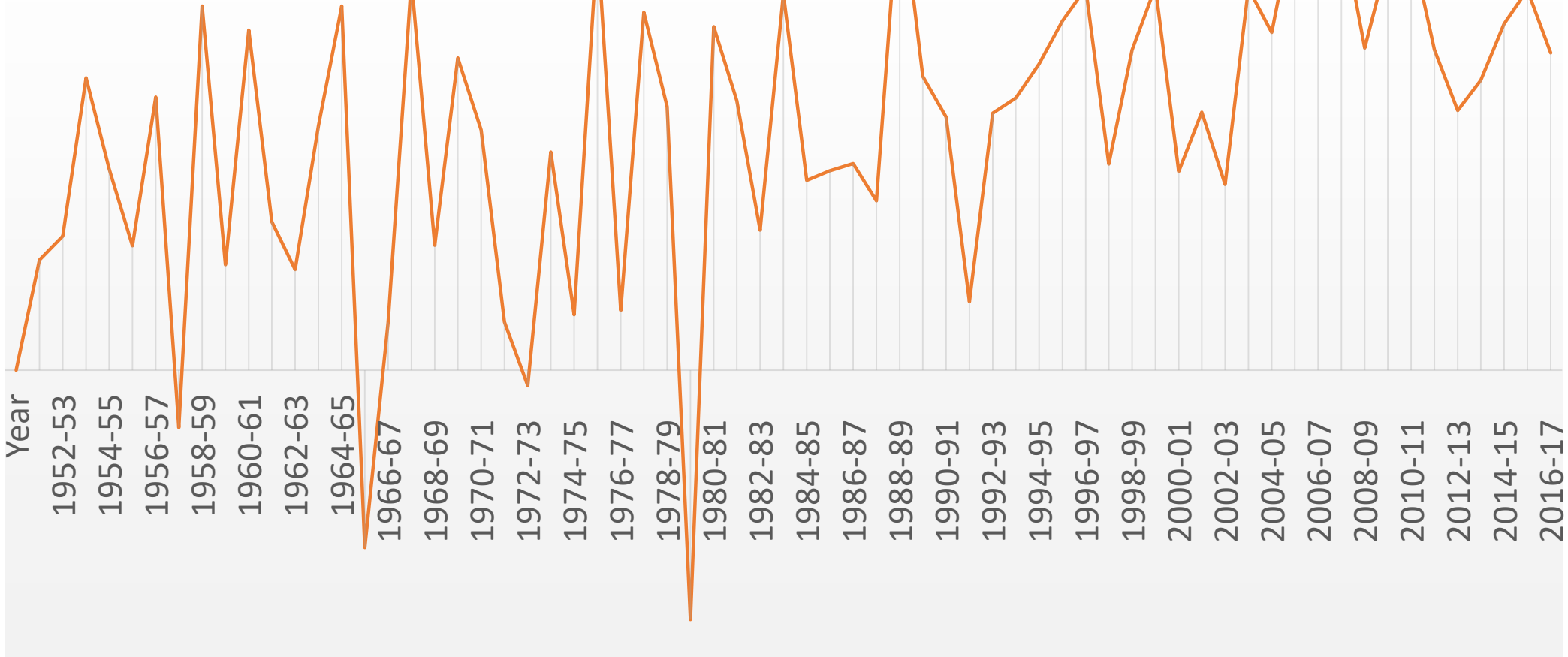
2008-09

2010-11

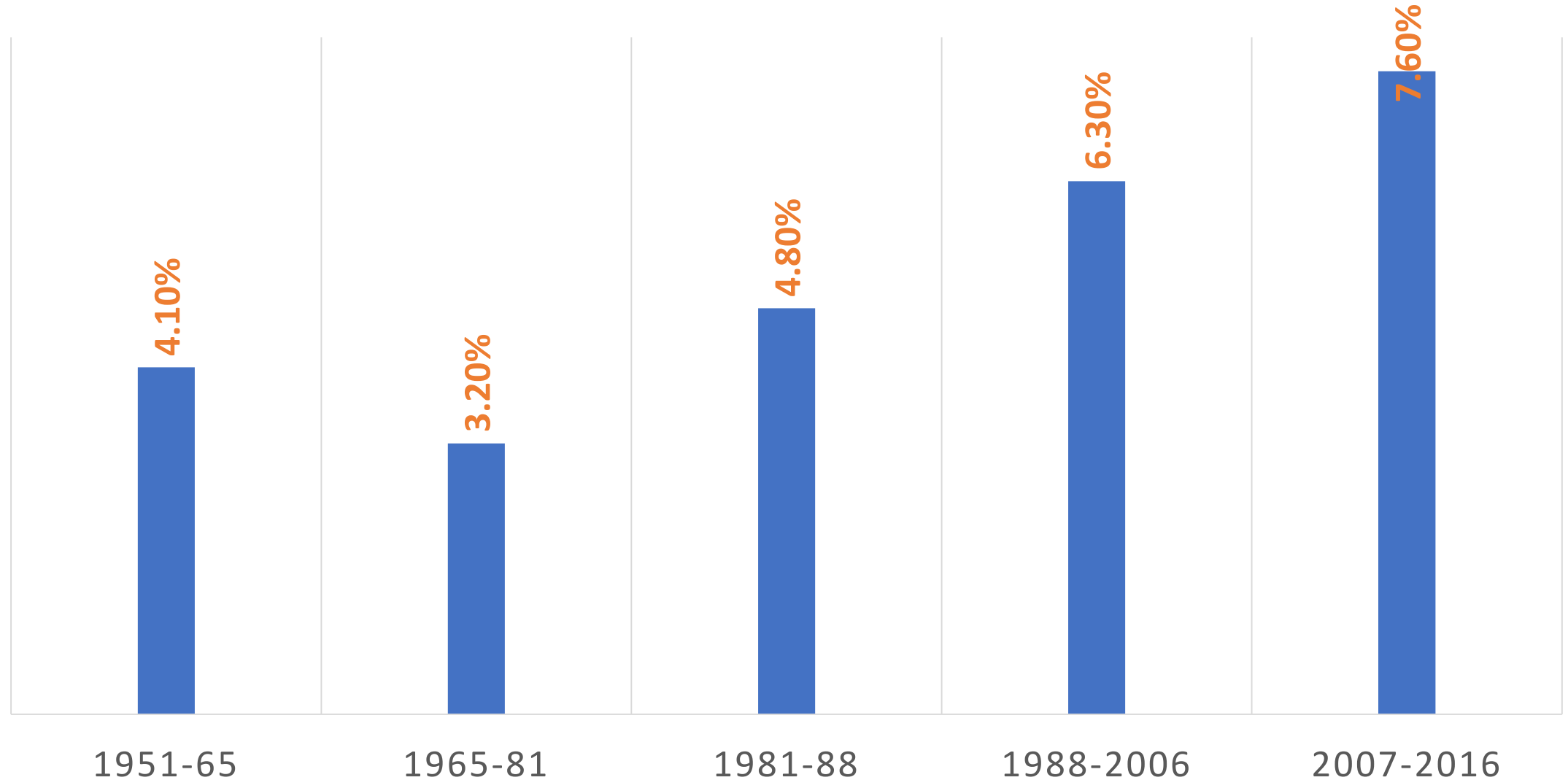
2012-13

2014-15

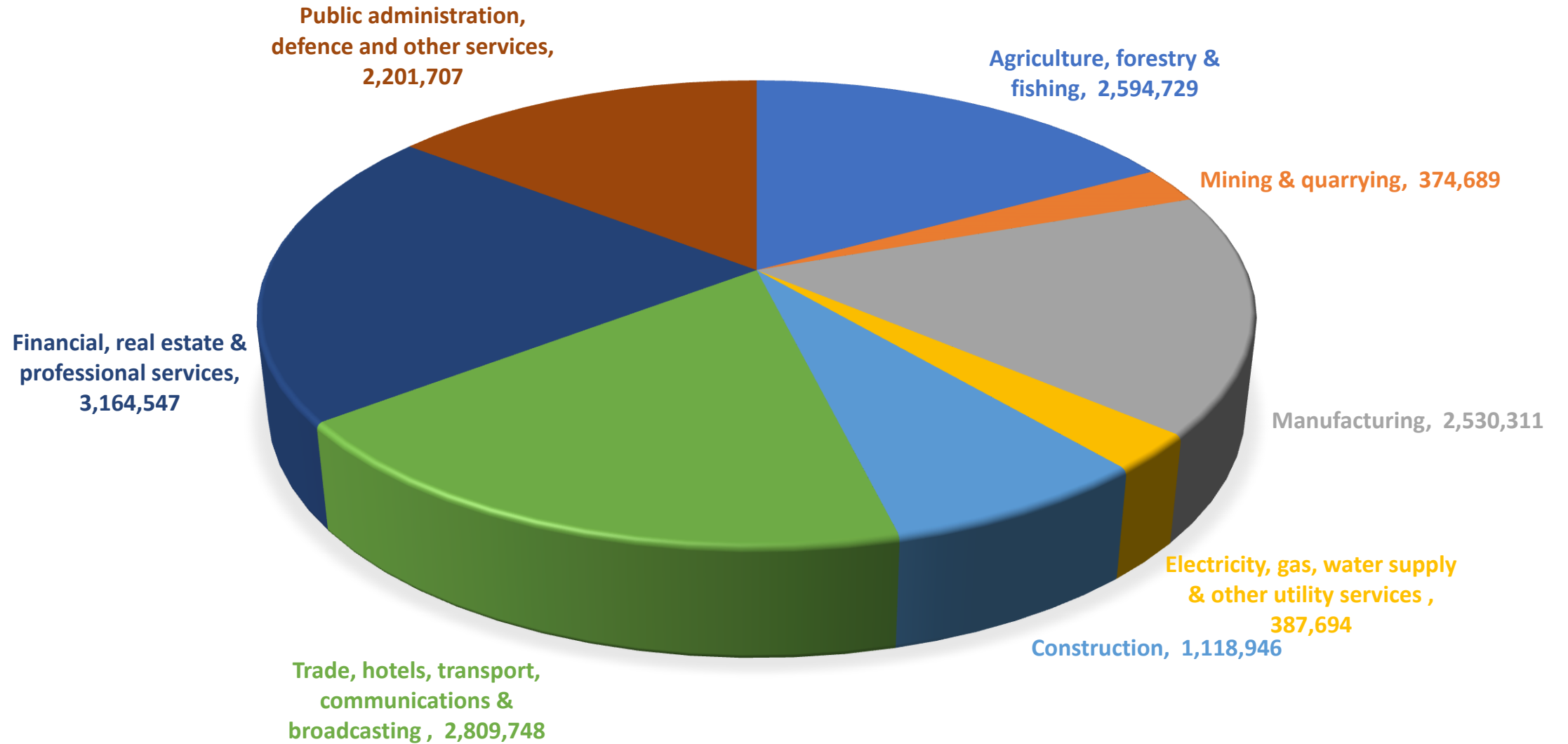
2016-17



Four or Five Phases of growth (GDP at factor cost)

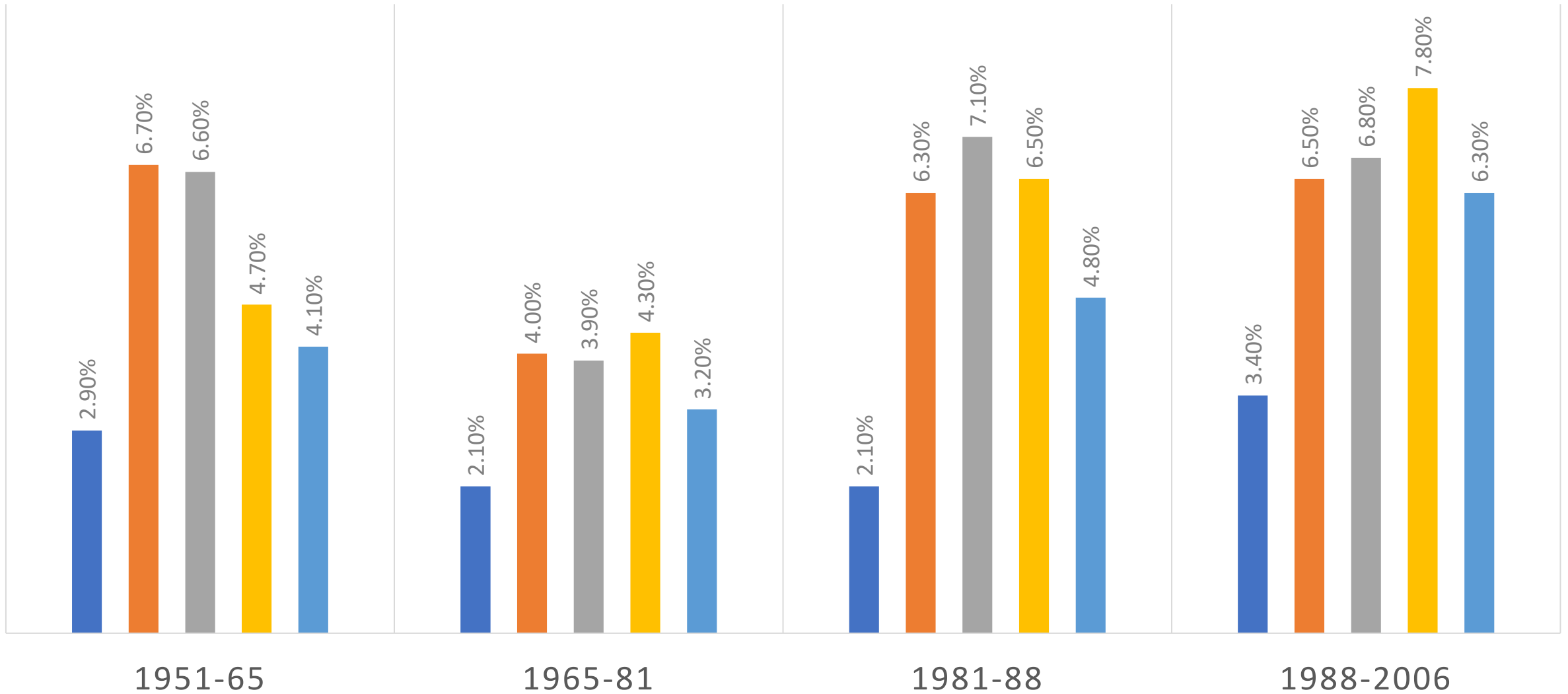


GVA 2017-18 RS 151,82,371 CR

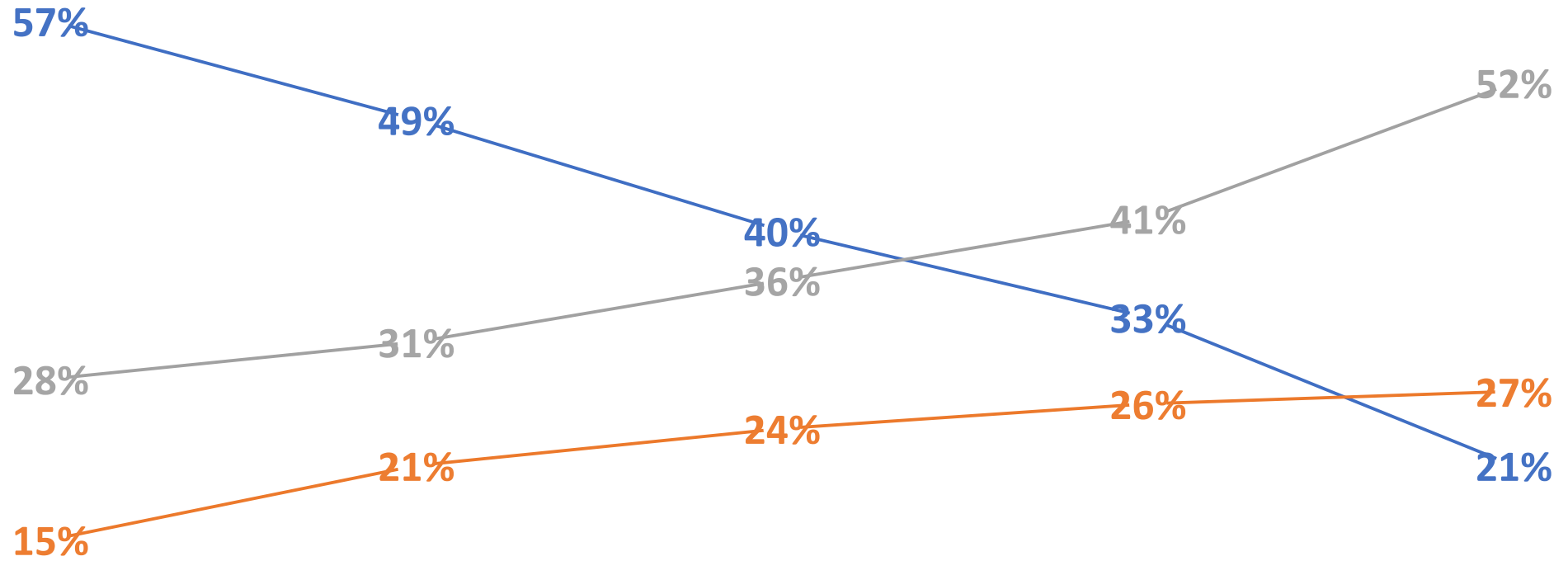


SECTORAL GROWTH RATES

■ Agriculture and allied ■ Industries ■ Manufacturing ■ Services ■ GDP



SECTORAL COMPOSITION OF GDP



1950-51

1964-65

1980-81

1987-88

2004-05

- -Agriculture and allied - -Industries - -Services

Puzzle of India's growth

- Why has liberalisation not been accompanied by much faster industrial growth as has been the case with China, Japan ?
- Likely reason – continuing restrictions on labour intensive products, Small scale industry reservations, inflexible labour laws
- Lack of large scale firms in light manufacturing sector such as apparel, toys, footwear, sports goods but high growth capital intensive manufacturing goods such as auto parts, pharmaceuticals
- How is it that the services sector – telecommunications, IT - is growing so fast?
- Likely reasons – not subject to labour market rigidities, operate in informal sector, easy to hire and fire

Linking policy and growth

- India grew at 4.1% in Phase –I which is big jump over 1 % or less during first half of twentieth century
- Emphasis during the colonial period was on law and order which switched over to development from 1947
- From 1950 to 1969, expenditure on development increased from 2.2% to 6.5% of national income
- In rural areas, the number of Government employees increased from 2,000 to 80,000
- R & D scientists – 62,000 ; Universities and technical schools have increased in number
- Private sector and agriculture have received bank credit

Linking policy and growth

- Essentially a liberal policy environment – open to foreign investments, trade and licencing were also liberal, expansionary fiscal policy and increased foreign resource inflow lead to macroeconomic crisis
- Phase – II – growth falls to 3.2% - socialism striking at vengeance
- Limits in product markets for businesses – big and foreign businesses – small scale sector reservations - nationalisation of banks, oil industry, coal mines
- External shocks – wars with Pakistan, oil price shocks, several droughts
- Phase – II stark contrast to spectacular growth in open economies of Taiwan, Korea

Linking policy and growth

- Phase –III growth increased to 4.8% - some liberalisation in tax policy, trade, industrial licencing, price controls, financial sector regulations
- Even though growth improved, the policy of borrowing abroad and fiscal profligacy lead to next crisis as well as reforms
- Macroeconomic stability – occasional double digit inflation, no large devaluations – no hyperinflation, balance of payments, capital flow or debt crisis unlike Latin America
- Policy changes are gradual and predictable due to democratic setup
- Political Stability
- Implementation capacity and institutional ability

Maddison (1971)

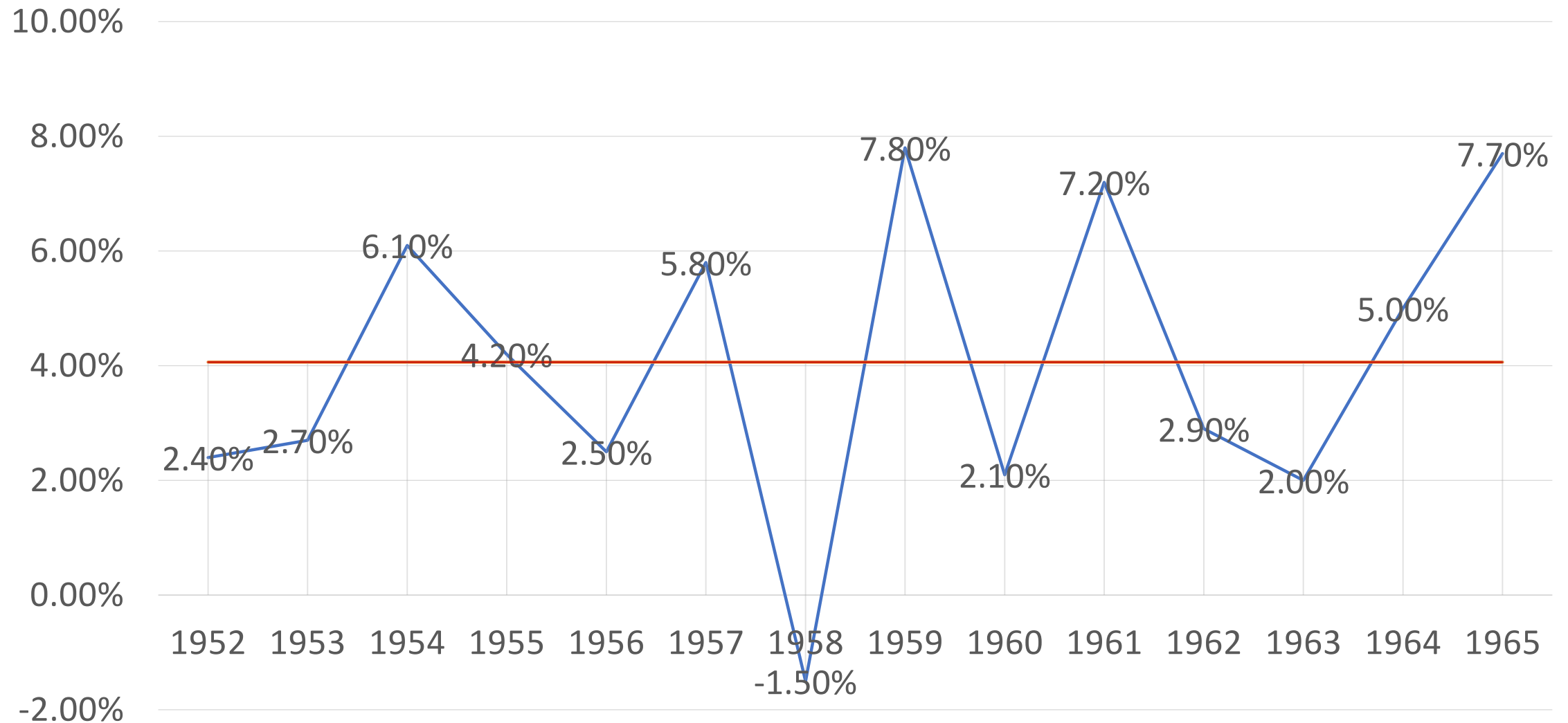
- “ Although India’s post war growth is much better than it was under colonial rule, we must also remember that acceleration of growth is a world wide phenomenon. It happened to almost every country. To judge the effectiveness of policy, we must make international as well as historical comparisons. In fact, India’s post war performance is well below average for developing countries , though not as much below as it was in pre war years. “

TAKEOFF UNDER A LIBERAL REGIME

Phase – I (1951-1965)



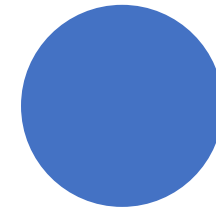
GDP Growth rate (real)- Average 4.1%



- “ The overall performance, in terms of absolute per capita incomes, of the first three plans on the whole is quite respectable, even though inadequate to India’s needs in view of her desperately low level of initial income and standard of living. “ (Bhagwati and Desai)
- The first five year plan (1951-56) was launched under a liberal policy regime
- The Industrial Policy Resolution (IPR -1948) envisaged an expanded role for the public sector and licensing to private sector, the policy remained liberal in practice till a balance of payments crisis in 1958

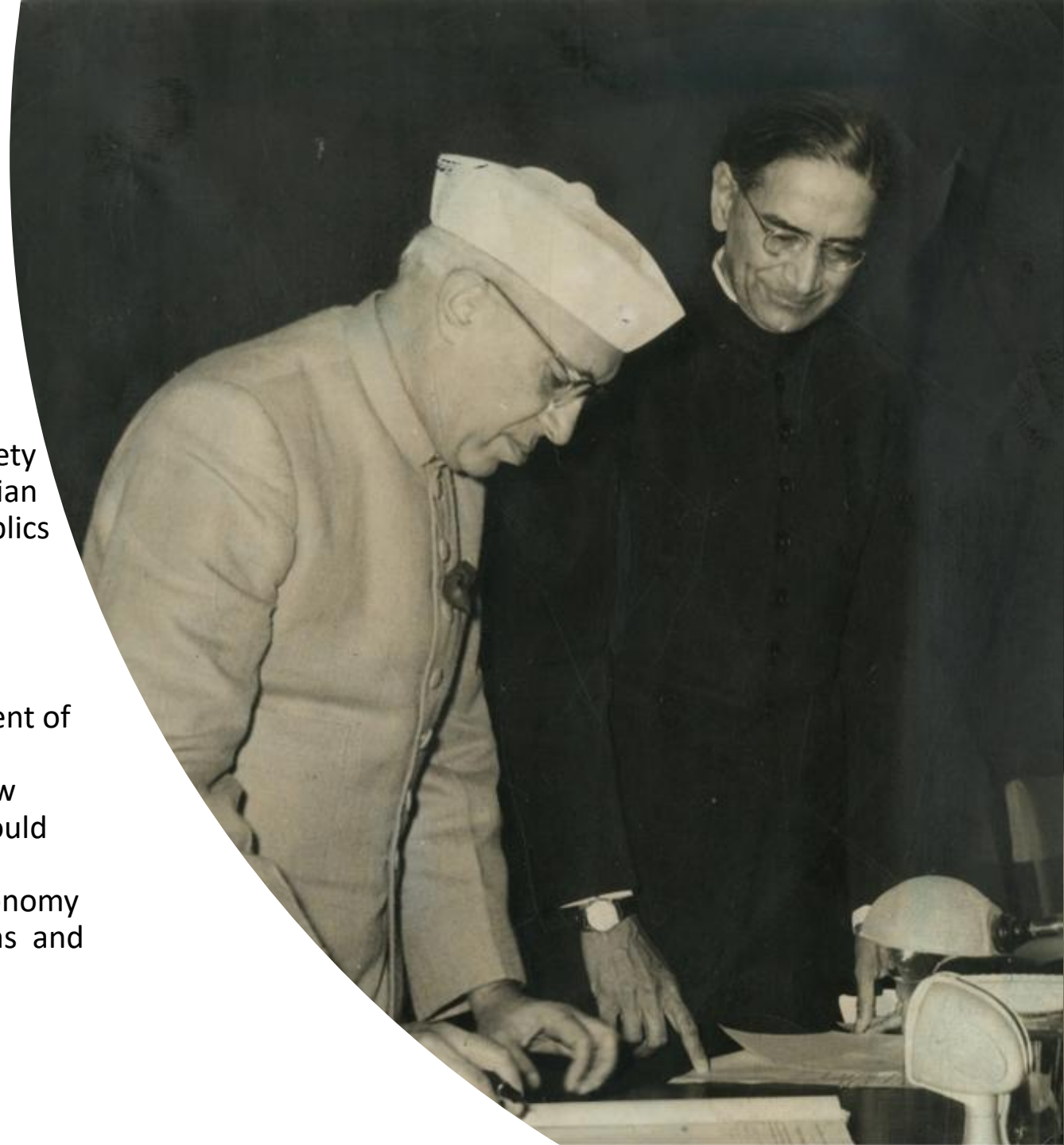


Policies during phase - I



1950s – Era of liberal trade and foreign investment policies

- Prime Minister Nehru's vision was to build a socialistic society with emphasis on heavy industry, on one hand, and Gandhian philosophy of small scale cottage industry and village republics on the other played a central role in policies of 1950s
- National Planning Committee (1938) under Nehru's chairmanship
- "The objective for the country as a whole was the attainment of national self sufficiency. The first charge on the country's produce should be to meet the domestic needs of food, raw materials and manufactured goods. Surplus production should not be dumped abroad but be used for exchange of such commodities as we might require. To base our national economy on export markets might lead to conflicts with other nations and to sudden upsets when those markets are closed to us. "





1950s – Era of liberal trade and foreign investment policies

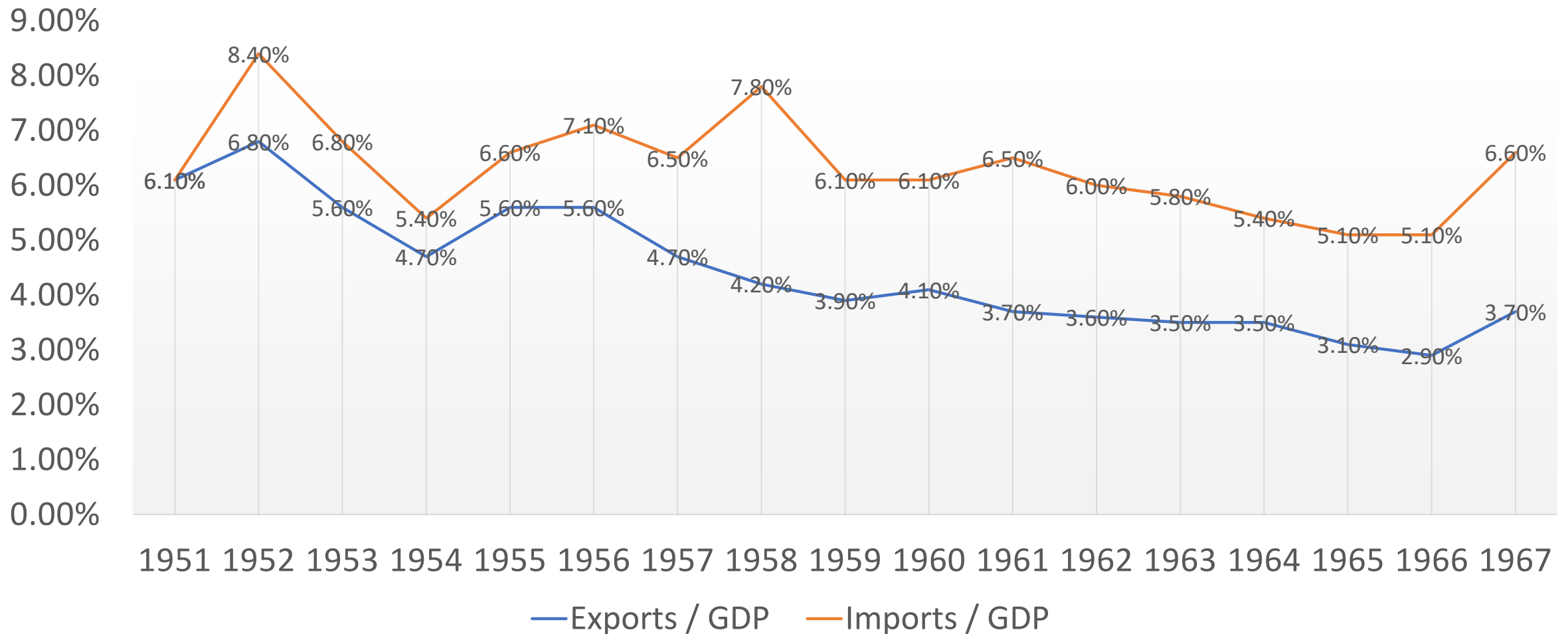
“ If we do not develop heavy industry here, then we either eliminate all modern things such as railways, airplanes and guns, as these things can't be manufactured in small scale industry or else import them. But to import them from abroad is be the slaves of foreign countries. Whenever these countries wished they could stop these things, bringing our work to a halt and we would remain slaves” – Nehru in an address to FICCI circa 1953

A liberal trade policy – imports and exports

- TT Krishnamachari, the dynamic commerce minister wanted the economy to develop fast and wanted anything that was not being produced in India imported and imported fast
- Consumer goods were also part of the basket of imports
- Established importers were allowed to operate freely
- Until 1957-58, imports as a proportion of GDP were not declining and only reduced after that
- The first import budget was presented in 1958 and allocation of foreign exchange regime started



Exports and imports as % of GDP



Restrictive Industry Policy Regime – Industry Policy Resolution 1948 , 1956

- State Monopoly – Atomic Energy, arms and ammunition, railways
- Basic Industries – exclusive rights to new investments – iron and steel, ship building, mineral oils, coal, aircraft production, telecommunication equipment
- Industries of national importance – state would regulate the licence – 18 industries and all others
- IPR 1948 was replaced by IPR 1956
- Schedule A – exclusively for state - category 1 and 2 of IPR 1948
- Schedule B - minerals, aluminium, machine tools, chemicals, fertilizers, synthetic rubber, road and sea transport – open to private sector but state also can invest
- By end of phase – 1 , a sizeable public sector started emerging

Private Sector Production and Investment – Industries (development and regulation) Act

- Industrial investment and production according to plan priorities
- Encourage small enterprises
- Achieve regional balance in industrial development
- Circumstances under which government can take over private firms management control
- Regulate distribution and prices of products
- Applicable to scheduled industries only – factory with 50 or 100 workers
- Registration and licensing provisions were introduced for “industrial undertakings”

IDRA – aiding development or just regulation?

- All industries in the schedule to be registered with the Central Government
- No capacity expansion without licence
- Exemption was given to small size industries
- Incentives were to be given only certain industries which could be defined on multiple parameters such as investment in plant and machinery, land, number of employees, quality and cost of the product, foreign exchange required for plant and machinery etc.
- Central government can assume direct management and control under certain circumstances
- Act empowered the Government to control the prices and distribution of products

IDRA implementation

- The licensing regime as well as release of foreign exchange for imports of equipment was smooth in the first few years of IDRA Act
- As the number of applications started to increase during the second five year plan, the situation deteriorated
- Till 1960, economy was small, civil servants were efficient and honest
- Only during 1960s, as the economy grew, the licensing regime became arbitrary and corrupt
- Big business houses started taking advantage of the licensing regime to stifle further competition and entry of new firms

Distribution and Price Controls

- Aimed at – allocation of adequate resources to priority sector at reasonable prices, to ensure equity in distribution and to control inflationary pressures
- Essential Commodities Act, 1955 gave enormous powers to Government over production, supply, distribution and purchase and sale price
- Controlled commodities – long list – iron and steel, cement, coal, fertilizers, cotton textiles, paper, sugar, motor cars, scooters, commercial vehicles, ethyl alcohol, molasses, drugs, kerosene and petroleum products, bicycles, tyres, vegetable oil, soap, matches

Agriculture

- Agriculture was not given adequate priority – outlays reduced during second plan
- Strategy was reliance on institutional model – land reforms, farm cooperatives not much on technocratic areas such as research and development, irrigation
- Institutional reforms had limited success
- Food grain production raised during first half of 1950s and stagnated towards the latter part largely due to increase in irrigation
- Productivity increases in agriculture were small

Summary Phase – I

- A conducive environment for growth – honest and efficient civil servants, judiciary, strong political leadership under Nehru and a vibrant entrepreneurial class , investments in infrastructure such as irrigation, power, transport and communications
- Planning was less complex during early stages of development
- Even though policies were towards increased controls, the necessary institutions required for implementation were not yet in place
- Easy entry of foreign capital meant machinery imports and technology upgradation took place
- During late 1950s and mid 1960s, growth was due to borrowing abroad and expansionary fiscal policies
- Big mistake – import substitution rather than turn towards exploiting the labour intensive export markets

SOCIALISM STRIKES
WITH A VENGEANCE
Phase – II (1965-
1981)





THE TIMES OF INDIA

BOMBAY: SUNDAY, JULY 30, 1960

BANKS ARE NAT

OWS

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HI, July 19.
Morarji Desai today decided
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led mixed reaction in
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s resignation after he
Mrs. Gandhi on Wed-

understood to have
an ordinance sign-
r. V. V. Giri, who
serving.

ren, who attended to-
as President, Mr. K.
re all born and ad-
the Governor's de-
f differences with the
h she had used Mr.
nda called



Prime Minister, Mrs. Indira Gandhi, stopped in New Delhi on Friday.

A vital step,

Kamar Chava happ.

"The Times of India" N
NEW DELHI.

THE Prime Minister,
she, receive tough
and criticism for some
major banks in the govt.

While her colleague,
Chavan, in a few days set
of it in "a bold step" a
towards nationalisation, the
leader, Mr. M. K. Menon,
"leader" from Mr. Manu
Mrs. Gandhi as a "secure
ward" for parliament, in
case Prime Minister'ship is

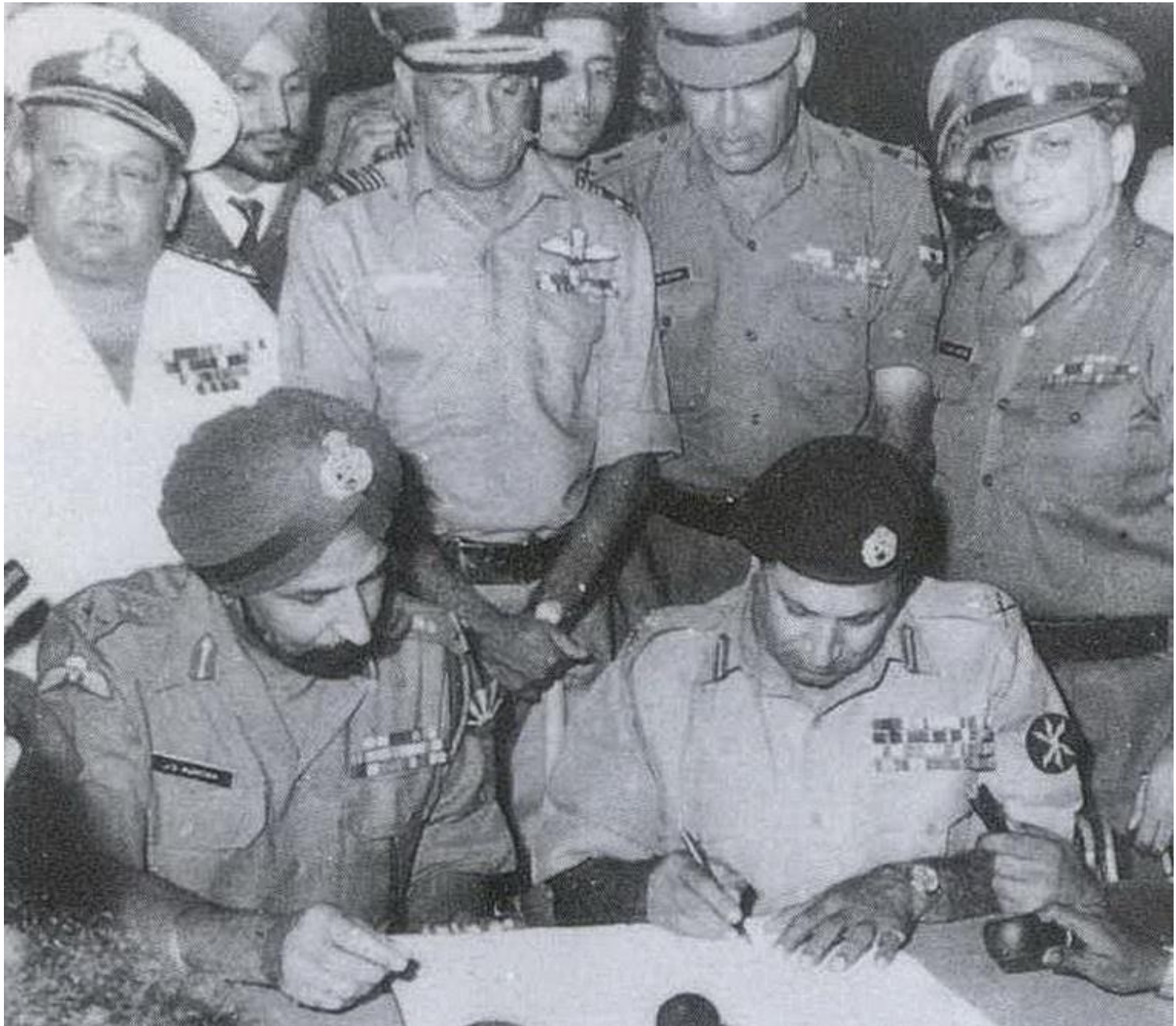
Mr. Menon was support-
r. B. Varghese, Jan 1959
who had been nominated
"left people" necessary as
the "left" leader. Some
he decided to quit their

He stated Mr. Menon,
the minister of an earlier
cabinet left the area
because of stress.

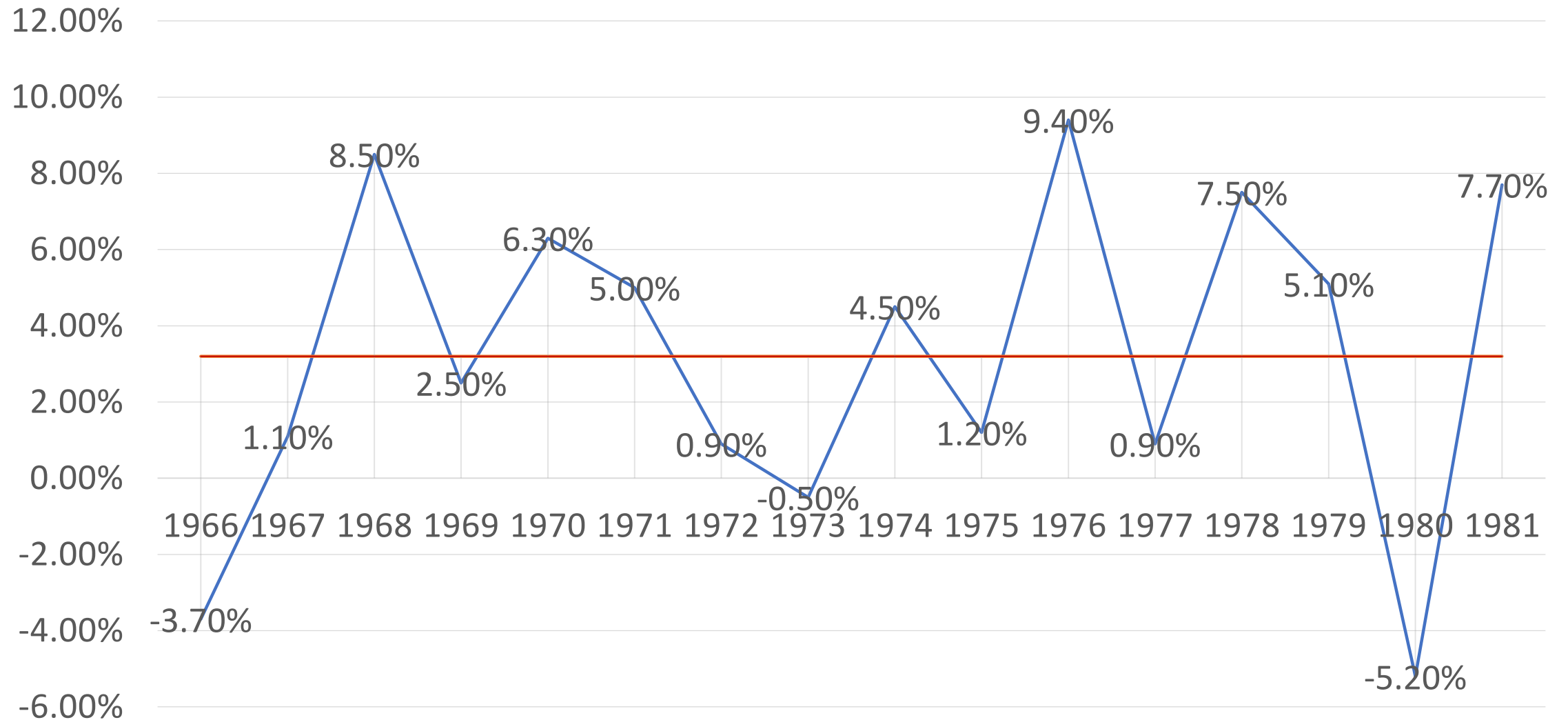
By the reaction in this
country, Mr. Menon
stated, Mr. Menon is
indicated the "Prime Min-
ister" role" and stated it
would "likely" would be
replaced.

New era

While the Congress,
were to alter the
scope of operations in a
single bill, Mr. B.
"New Era" were left
Kamraj and Mr. Arde
personally ready to go. Mr.
Prasad did not see the "N



GDP growth rate phase II - average 3.2%



Phase II: Socialist Agenda

- Mrs. Gandhi, prevailed over centre-right rivals within the Congress Party (the “syndicate”) by 1969 and moved forward with her populist /socialist /state directed economic planning agenda
 - Regulation of Industry (MRTP)
 - Restrictions on foreign investment
 - Import controls and import licensing
 - Labour laws (IDA)
 - Land ownership restrictions
 - Bank nationalisation

Investment Policy

- Monopolies and Restrictive Trade Policies Act (1969)
 - Approval of investment activity only if it did not lead to an increase in economic concentration
 - Motivated by the perceived concentration of economic power in the hands of a few large business houses
 - Favoured small and medium enterprises
- Foreign Investment
 - Strict scrutiny of large scale foreign investment projects (Foreign Investment Promotion Board, FIPB)
 - Limits on foreign equity share (Foreign Exchange Regulation Act – FERA)

Labour Laws

- Industrial Disputes Act (addition of Chapter V.B) :
 - Establishment with 300 or more workers not permitted to retrench a single worker, without appropriate government permission; permissions were rarely given
 - In later years, this rule was extended to firms with just 100 workers
- Worker efficiency fell, strikes
- Firms moved to capital intensive industries and chose capital intensive technologies

Phase II: other measures

- Banking Companies Act
 - Nationalisation of all banks with deposits greater than Rs 500 million
 - Potentially THE most pernicious action – why?
- General Insurance Act
 - Nationalisation of Insurance
- Urban Land Ceiling Act
 - ceiling on land ownership in urban areas
 - Holders of excess vacant land were to surrender the land to government
 - lead to widespread shortage of urban land
 - widespread corruption to circumvent the “surrender” rules

Growth rate across sectors

- Growth rate fell across all sectors but the sharpest decline was in industry – fell from 6.7% in phase –I to 3.6% in phase –II
- The spurt in services seen in last five years of phase – I subsided
- What happened – external shocks – two consecutive drought years, 1965-67, wars with Pakistan in 1965, 1971, two more droughts in 1971-73, oil price shock
- Decline due to droughts more than offset gains of green revolution
- Slowdown in industry is due to its strangulation by highly restrictive trade policies along with droughts and oil price shocks

Political changes

- Nehru died in 1964 and was succeeded by Lal Bahadur Shastri , who brought back focus to agriculture sector from industry and laid the foundations for green revolution but died untimely in 1966
- Indira Gandhi succeeded Shastri and served in office till 1984 except for a brief period between 1977-1980
- Mrs Gandhi's relationship with US and the syndicate of Congress party played a crucial role in influencing policy decisions
- India refused to lend support to US war on Vietnam much to US dislike, but had to depend on US for food grains due to droughts
- India imported 25.4 million tons of food grains during the first four years of third plan and had to import further import 19 million tons during 1965 - 66, much of it from US under PL 480 – “ship to mouth” phase

Political and economic changes

- The organisational wing of Congress party (Syndicate) wanted to dominate and rule India in Indira Gandhi's name, who was famously called "gungi gudiya"
- To contrast herself from the syndicate, Indira Gandhi moved towards populist policies of the left and blamed them for the losses in 1967 general elections
- Bangladesh was formed in 1971 after the war with Pakistan which India won and this boosted the popularity of Mrs Gandhi
- The droughts of 1971-72, oil shock caused high inflation and slow down of the economy
- June 1975, Allahabad High Court ruled Mrs Gandhi's election as illegal and she declared emergency
- Emergency was lifted in January, 1977 and in the ensuing elections Congress was defeated
- Mrs Gandhi came back to power in 1980 as Janata party rule collapsed because of internal struggles and inability to govern

Strangulation of Industry

- Monopolies and Restrictive Trade Practices (MRTP) Act, 1969 was aimed at regulation of large firms and increasing market power – Its origin was exploitation of the licensing regime by big business houses to concentrate economic power
- MRTP companies were basically defined on size of assets – more than Rs 20 cr or market share of 33% or more – several restrictions were placed on them in terms of licencing, capacity addition, mergers and acquisitions
- Tighter restrictions on foreign investments and foreign firms culminating in Foreign Exchange Regulation Act (FERA)
- Small scale industry reservations in 1967
- Tightening of licensing through Industrial Licensing Policy, 1970



Shoes, shirts, cricket bats —
what is common to them?

Strangulation of Industry

- Foreign investment was regulated through setting up of Foreign Investment Board(FIB) which would decide the fate of projects which have foreign investment up to rs 2 Cr beyond which it would require the cabinet approval
- Specific lists of products in which foreign investments and import of technology were permitted
- FERA act of 1973 gave the final blow to foreign investments in India
- FERA required that all companies that had more the 40% foreign equity to take permission from RBI and dilute their equity to leas than 40% - many foreign companies wound up their business

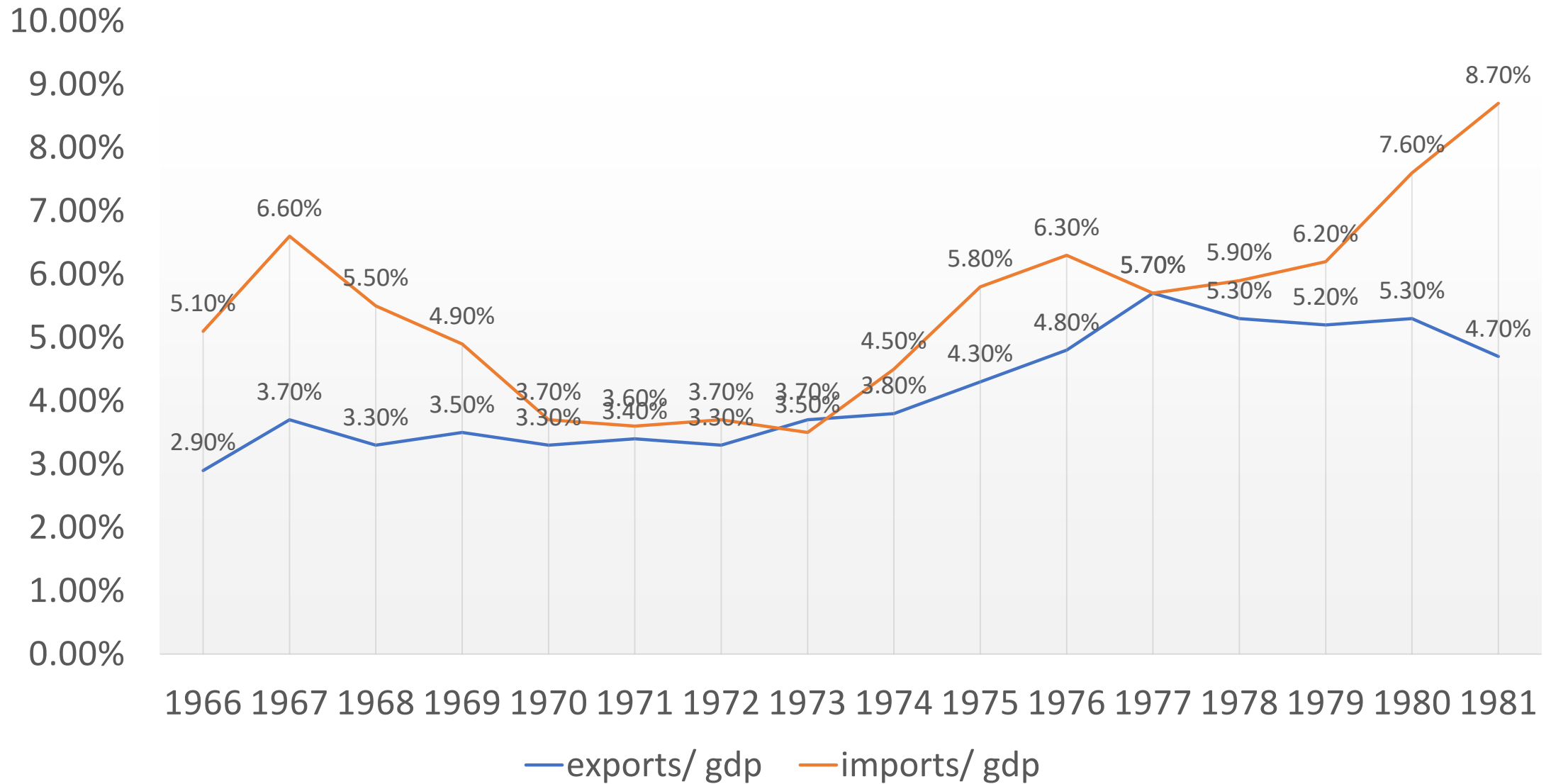
Licence permit raj – Industrial Licensing Policy of 1970

- Large industrial houses and foreign firms were confined invest in “core and heavy” sectors only
- Restrictions were placed on imports of machinery
- Small scale industry reservations and preference to cooperative sector in agro industries
- SSI reservations started with 47 items and kept on expanding to 324 items – clothing, knitwear, shoes, leather products, sports goods, toys, stationery, office products, furniture, simple electrical products were on the list – the very same labour intensive, light manufacturing products which have helped Korea, Taiwan and China to grow
- In 1966, industrial licencing requirements were removed for 41 industries – these came back in 1970
- Diversification and capacity addition required approval

Industrial Policy Measures

- Genesis- committees which reviewed the policy in mid 60s' have concluded that the licensing process has become arbitrary & unpredictable, has led to concentration of economic power in big business houses
- Mrs Gandhi embraced socialism in a big way to win back popular support which had lost 1967 election in several states
- A set of policy measures which favoured small entrepreneurs and complete exclusion of other enterprises from manufacturing of labour intensive products
- Even in capital intensive sectors, the preference was small and medium enterprises while big industry was restricted to a small number of industries
- Two track approval process and exclusionary product lists, FERA drastically reduced foreign investment and technology – IBM and Coca-Cola left India

Foreign Trade



Foreign Trade

- Import controls and export subsidies returned with full force
- Import licensing covered all imports and foreign exchange control was applied with stringency
- Six monthly import list along with users of such imports and quantity restrictions
- Imports and exports as a proportion of GDP bottomed out by 1970s
- Exports grew quite rapidly albeit on a small base due to rupee depreciation from 1970 and reached a high of 5.7% in 1977
- Increased remittances from workers who migrated to gulf due to increase in oil prices and external borrowings allowed to increase the imports to grow much faster reaching to 8.7% of GDP in 1981

Factor market regulations: labour and land

- The industrial disputes act was amended in 1976 and required that the government has to permit retrenchment of even a single worker – applicable to all establishments employing more than 300 workers, this was revised in 1982 downwards to 100 workers
- Exit of firms was impossible as no firm was allowed to shut down
- Labour strikes became endemic as labour unions became very powerful
- Entrepreneurs moved away from labour intensive industries towards capital intensive industries



Factor market regulations: labour and land

- Urban land ceiling act was brought in 1976 and all entities were prohibited to hold more than 2000 square meters – excess land had to be surrendered to Government for a small compensation
- Law's objective was concentration of wealth and to end profiteering from speculation
- Compliance with the act was poor; loopholes and corruption ensured the failure of law
- This law distorted land markets in a major way and along with rent control made land prices in cities like Bombay the highest in the world
- The failed firms such as textile mills in Bombay could not liquidate prime lands as the urban land ceiling act forbade it.

Banks Nationalisation

- Operations of the commercial banks were confined to urban areas
- In 1955, State Bank of India was established by taking over Imperial Bank of India
- In 1969, there were 79 scheduled and 16 unscheduled commercial banks
- Rural areas accounted for 75% population but 20% of bank branches
- Government felt that banks ignored small enterprises and lent only to big corporations who were the owners of the banks
- Power struggle between Mrs Gandhi and syndicate lead to nationalisation of banks

Banks Nationalisation

- Banking companies (acquisition and transfer of undertakings) Act, 1969 nationalised all banks with deposits more than Rs 50 Cr
- 14 banks and 54% of all bank branches were nationalised
- Including SBI, 84% of all branches were now under state control
- In 1980, another six large private banks were nationalised
- The proportion of rural branches jumped from 22% in 1969 to 35% by 1972
- Rural bank deposits increased from 3% in 1969 to 13% by 1981
- Rural credit and priority sector lending also increased by three times in 1981 compared to 1969
- Success or failure? Cost of branches, NPAs, incentives for managers in public sector vs. private sector



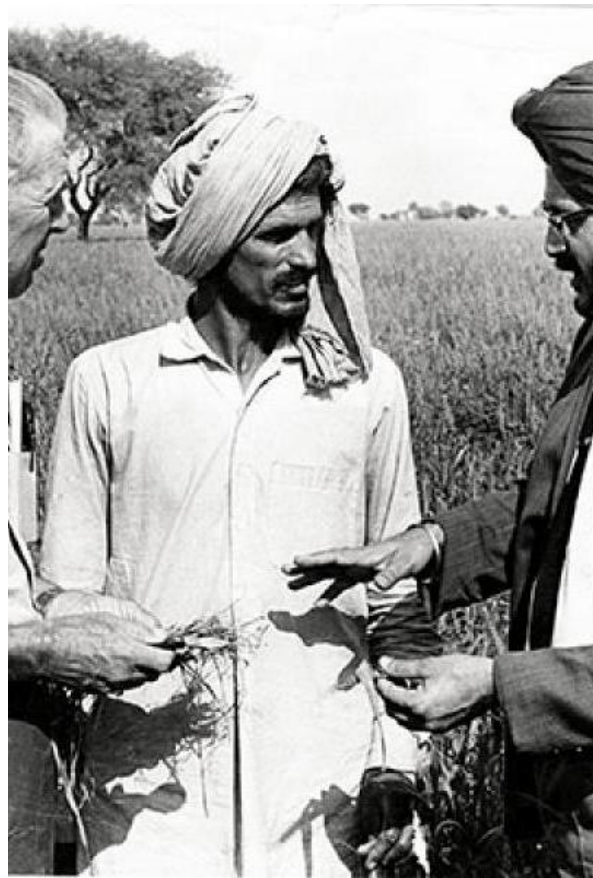
Bank Nationalisation

- Rationale

- Credit is key driver of economic activity and enabling the poor to make productive investments
- But private banks typically do not locate in rural areas – why?
- So goal of nationalising banks was to democratize access to credit for the poor (politically very popular)

- Impacts

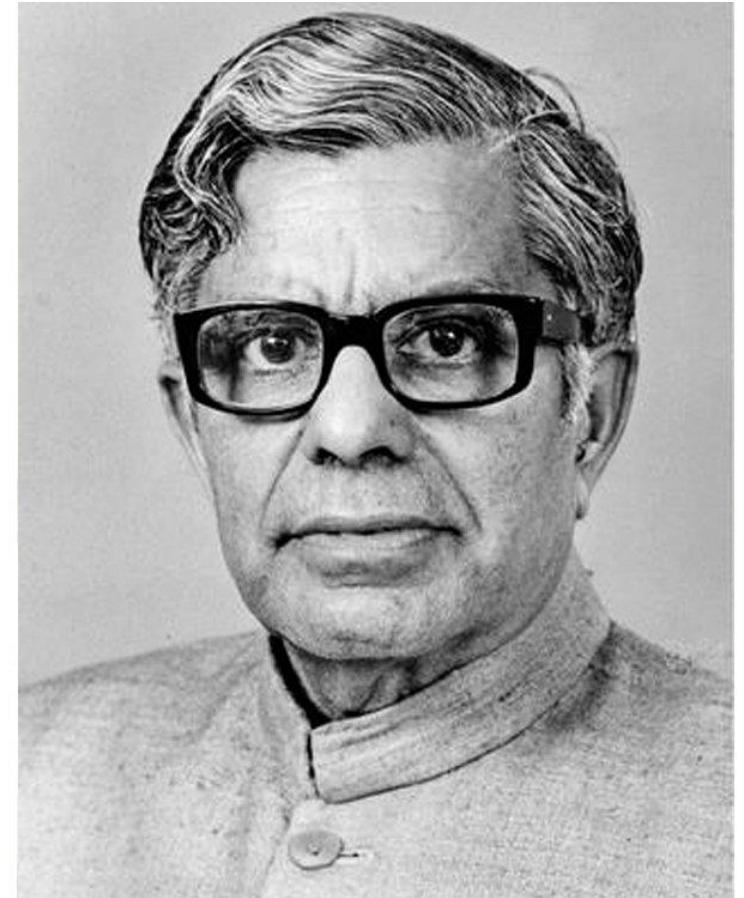
- Positive: Reduction of poverty ?
 - But cannot distinguish from loan forgiveness
- Negative: Politicization of credit decisions
 - Loan waivers for poor / farmers before elections
 - Preferential treatment for political donors
- Widespread misallocation of credit ; bank balance sheet under severe stress requiring taxpayer bailouts



Green Revolution

Green Revolution

- The most important positive development in Phase – II is green revolution
- Lal bahadur Shastri brought back focus to agriculture and appointed C. Subramaniam as the agriculture and food minister
- The dependence on food imports and the intrusive policy of US was so humiliating that at one time Shastri asked all Indians to miss a meal every week
- A quantum jump in the food grain production was the highest priority
- High Yielding Variety of wheat from Mexico were found to double the yields in university field plots
- Even though the scientists from IARI were not very much convinced, the minister pushed for the introduction of these seeds



Green revolution – a lesson in policy making and implementation

- The cabinet ministers, left parties, economists, finance minister TTK were all opposed to HYV seeds
- Subramaniam converted five acres of lawns in his bungalow in Delhi into a demonstration farm successfully and convinced every one
- Based on his assessment of land quality, climate and entrepreneurship the HYV seeds were distributed in Punjab, Haryana and western UP
- In 1967-68, India produced 17 million tons of wheat compared to the previous record of 12 million tons
- The success ensured that policy gained acceptance and was spread to other crops and geographies

Green revolution – institutions

- The Agriculture Price Commission (APC) was set up to minimum support prices for farmers in order to assure remunerative prices for farmers even if there is a bumper crop leading to depressed prices
- Food Corporation of India (FCI) was set up to carry out price support operations, distribute food grains throughout the country for public distribution system and to maintain satisfactory level of buffer stocks
- National Dairy Development Board (NDDB) was set up to promote milk production
- Indian Council of Agriculture Research played an important role in indigenising HYV seeds
- India faced a food crisis in 1971-73, due to crop failures, but was able to tide it over with the buffer stocks of FCI

Green revolution – institutions & discontents

- Over time, FCI turned into a large, corrupt and inefficient organisation and wasted enormous public resources
- Political pressures lead to high procurement prices leading to high levels of procurement and large food stocks far beyond the requirement for any eventuality and even the FCI storage capacity
- PDS became a way of ensuring above market prices to rich farmers of Punjab, Haryana and Andhra Pradesh
- Food subsidy, procurement prices are major distortions on the product side of agriculture markets

Summary Phase – II

- The economic performance is during the period of 1965-81 is the worst in independent India's history
- External shocks – droughts, wars, oil price shocks put a strain on country's meagre resources
- By being a closed economy, India missed out on the opportunities created by a rapidly growing world economy
- India had a good chance of achieving the growth rate of 8% -9% (like Korea, Taiwan) if the policy regime was outward oriented
- As savings and investments have gone up substantially, the decline in growth is due to decline in productivity
- Even though agriculture productivity improved, increasing support prices and fertilizer and other input subsidies lead to lesser investments in infrastructure

Summary Phase – II

- Policies put in place during this phase, created institutions and vested interest which were difficult to reverse
- privatisation of banks and public sector institutions is very difficult to do even now – removal of urban land ceiling act is still not done across all Indian states in spite of political consensus that it is hurting growth in urban areas
- Policies aimed at equitable distribution of income and wealth, effectively killed the incentive for creating wealth
- Fear of expansion of big business houses excluded them from all but a few highly capital intensive sectors – option was to allow them to expand in many areas so that they would generate employment and wealth

Summary Phase – II

- SSI reservations excluded all big firms from labour intensive industry and India was not able to compete in the world market for these products – SSI produced low quality products for domestic markets, who in turn were denied the best products of the world through import restrictions and substitutions
- Labour laws ensured that no labour intensive industry came up in the organised sector
- Equity driven policies were also largely anti growth and as growth is the best form poverty alleviation, these policies were also ironically anti poor



Phase III (1981-88) Liberalisation by Stealth

Phase III

- Industrial performance during the first half of 1970s was dismal at 2% in the period 1970-75 leading to criticism and advocacy for relaxation of controls - Second half of 1970s saw piece meal deregulation
- In 1975, Mrs Gandhi tried to nationalise the wholesale wheat trade but it failed showing the limits of how far the agenda could be pushed
- Consumer price index increased by 21% in 1973-74 and 27% in 1974-75 clearly showing that the policies were not working
- Allahabad high court verdict declaring Mrs Gandhi's election as illegal lead to imposition of emergency for 19 months
- Janata party came to power in 1977 but lost to Congress in 1980
- Militant movement in Punjab lead to operation Bluestar and finally Mrs Gandhi was killed by her own Sikh bodyguards

Phase III (1981-89): Tentative Liberalisation

- Industrial De-regulation
 - Broadening output mix – firms permitted to change the output mix (trucks vs cars)
 - Capacity expansion – limited set of industries
- Trade Reforms
 - Declining number of “restricted” and “canalised” goods – goods which could only be imported through government agencies
 - Goods not produced domestically to be licenced for import by inclusion in the open general licence (OGL)
 - Quotas converted to tariffs
 - Export incentives
- Privatisation of Telecommunications
- Rationalisation of tax system: Modified Value Added Tax

Phase III

- Rajiv Gandhi came to power in 1984 with a historic mandate
- India's first PM who has grown up mostly in Independent India and with no socialist baggage –came to power with the aim of launching India into 21st Century
- Economic liberation began in earnest in the first two years of his rule and also improved relationship with USA
- Latter part of the rule was marred by Bofors corruption scandal and also LTTE fiasco in Srilanka
- VP Singh succeeded Rajiv Gandhi as PM in 1989

Deregulation of Industry – three waves 1975-79, 1979-84 and 1985-89

- Diversification – firms in engineering industry were allowed to change the product mix within existing capacity known as broad banding
- Recognition of capacity over licenced capacity on basis of modernisation, export promotion
- Automatic capacity expansion up to 25%
- Delicensing of certain sectors which don't need foreign exchange
- SSI asset limit was also increased



Deregulation of Industry – three waves 1975-79, 1979-84 and 1985-89

- Capacity expansion exemption limits were raised
- In 1984, telecommunication equipment manufacturing was opened to private sector
- MRTP asset limits were raised so that 50% of big businesses were no longer under MRTP restrictions
- Pharmaceutical industry was delicensed
- The industry growth rate increased to 6.3% compared to 4.0% in the previous phase



Trade liberalisation

- Import policy was issued in the form of a complex “red book”
- By 1972-73, the ratio of imports to GDP fell to 3.5%
- “ import substitution policies were followed with little or no regard to costs. This resulted in an extremely diverse industrial structure and high degree of self sufficiency but many industries had high production costs. There was also the problem of poor quality and technological backwardness, which best even low cost sectors with comparative advantage such as textiles, garments, leather goods, many light industries and cotton. By 1976, the result of obsolescence of capital stock and technology became apparent and a steady liberalisation of capital equipment and technology started soon after. “ Pursell

Other reforms

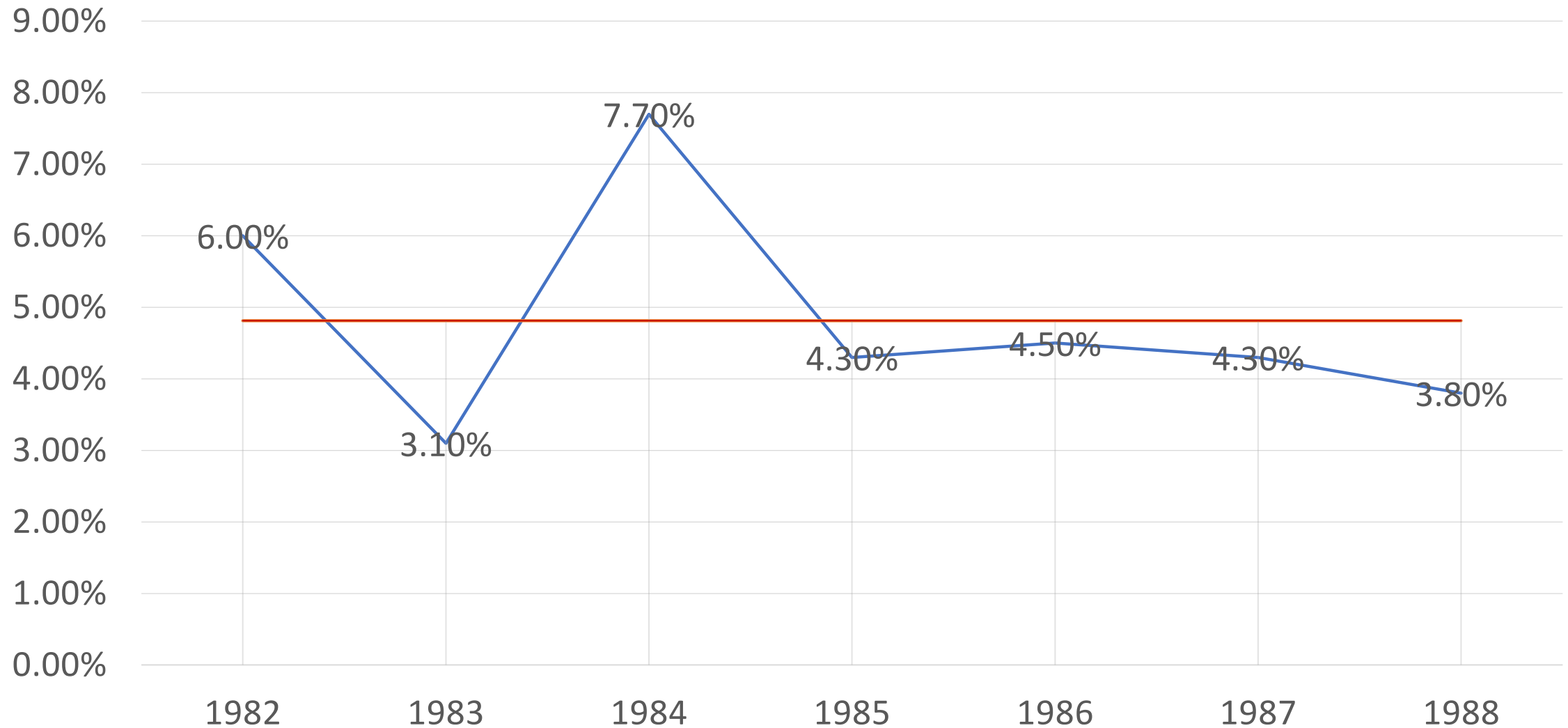
- Price and distribution control on cement and aluminium were abolished – decontrol of cement eliminated black market and expanded production and brought free market prices to control level within a short period of time
- Taxation – multiple taxes were converted into a modified value added tax (MODVAT) regime
- Telecom department was created and first technology park was opened in Bangalore
- Education – National Policy of Education was announced in 1986

Trade liberalisation

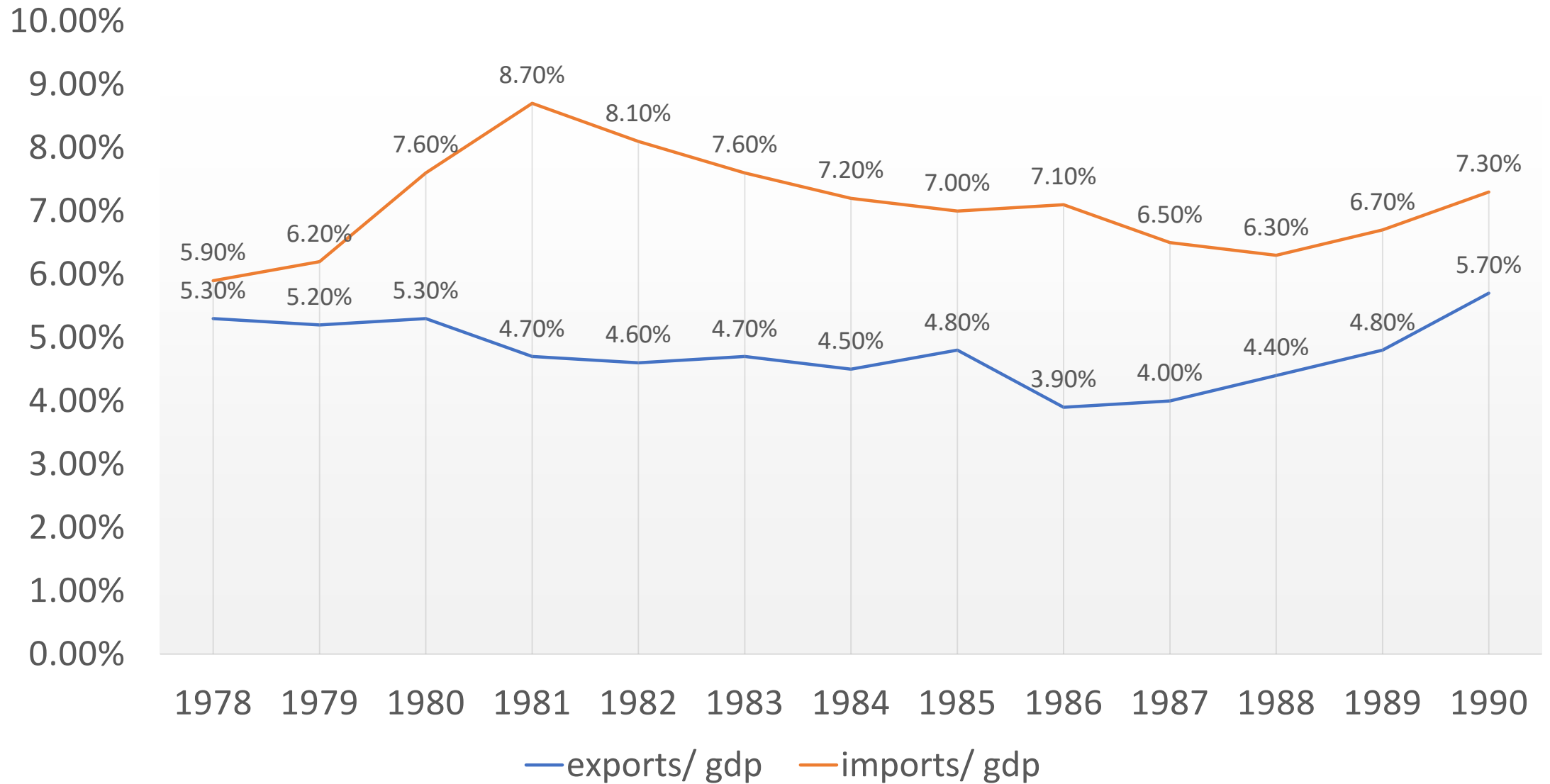
- The complex red book was replaced with a three part list – imports that were banned, restricted and unrestricted (open general licence)
- Products were divided into consumer, capital and intermediate goods
- Imports of several items still remained with canalizing agencies such as FCI for cereals, State Trading Corporation for edible oil, Indian Oil Corporation for oil
- The share of canalized imports declined over a period of time
- OGL lists steadily expanded
- Several exports incentives were introduced and expanded
- The exchange rate was set at a realistic level which helped expand exports and in turn reduced pressure on foreign exchange needed for imports



GDP growth rate phase III - average 4.8%

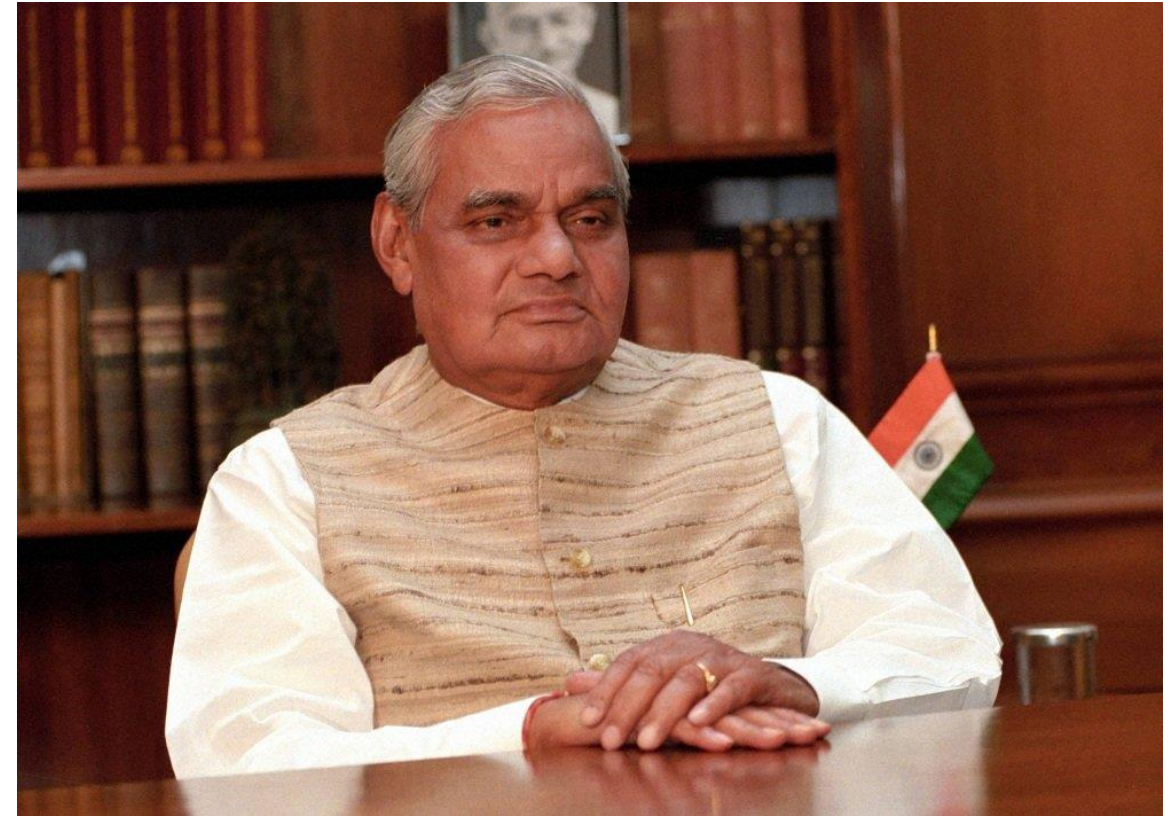
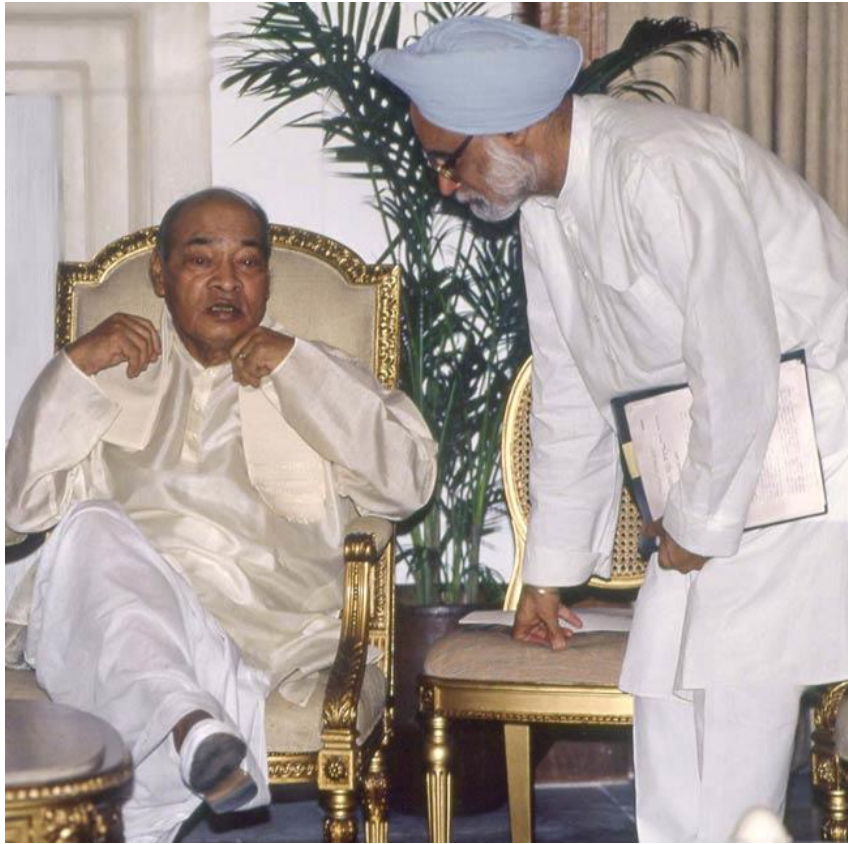


Foreign Trade



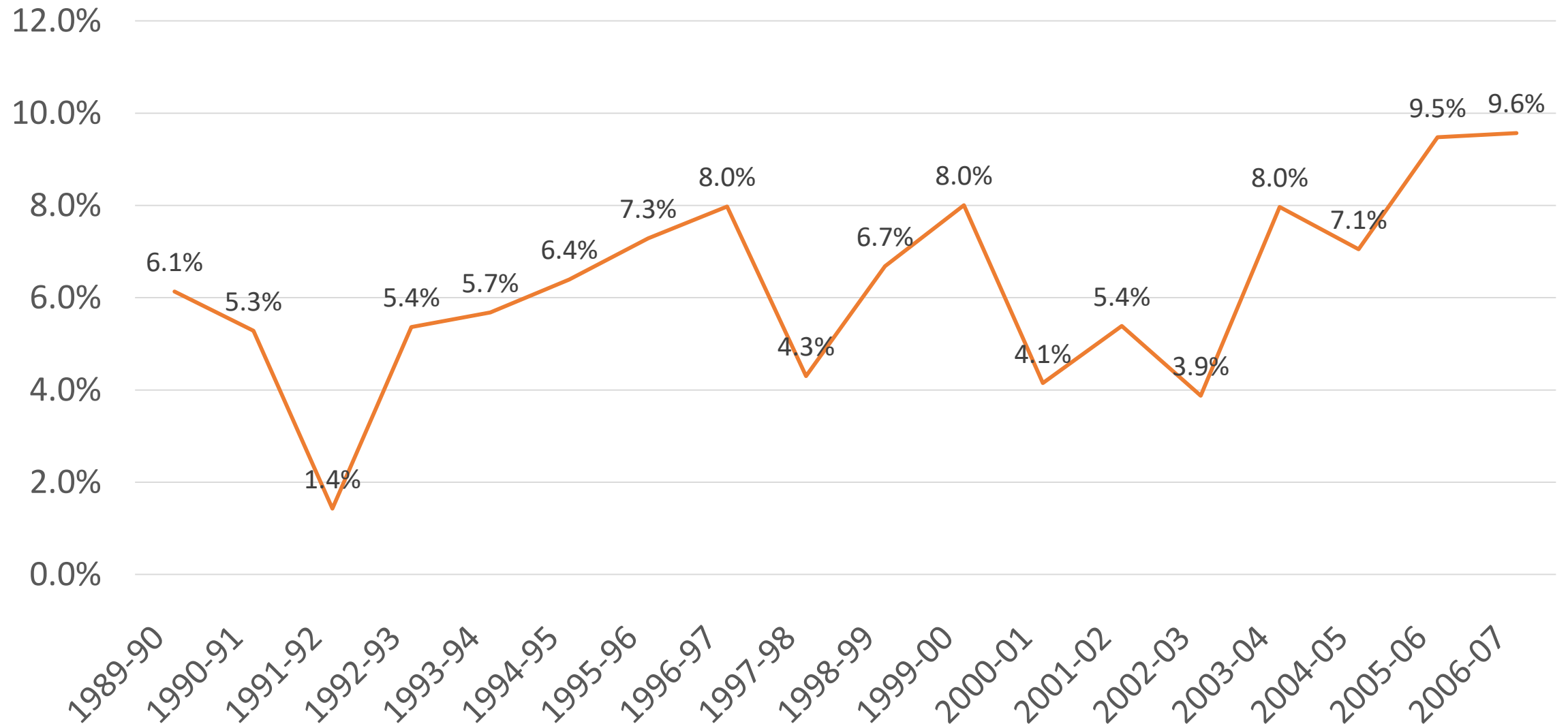
Summary of Phase III

- GDP growth rate shifted from 3.2% in the previous phase to 4.8% in phase III
- The progressive and piecemeal liberalisation done during phase –III lead to original rate of growth achieved in Phase – I with a small bonus
- When the initial distortions are large, even a small liberalisation brings in large changes

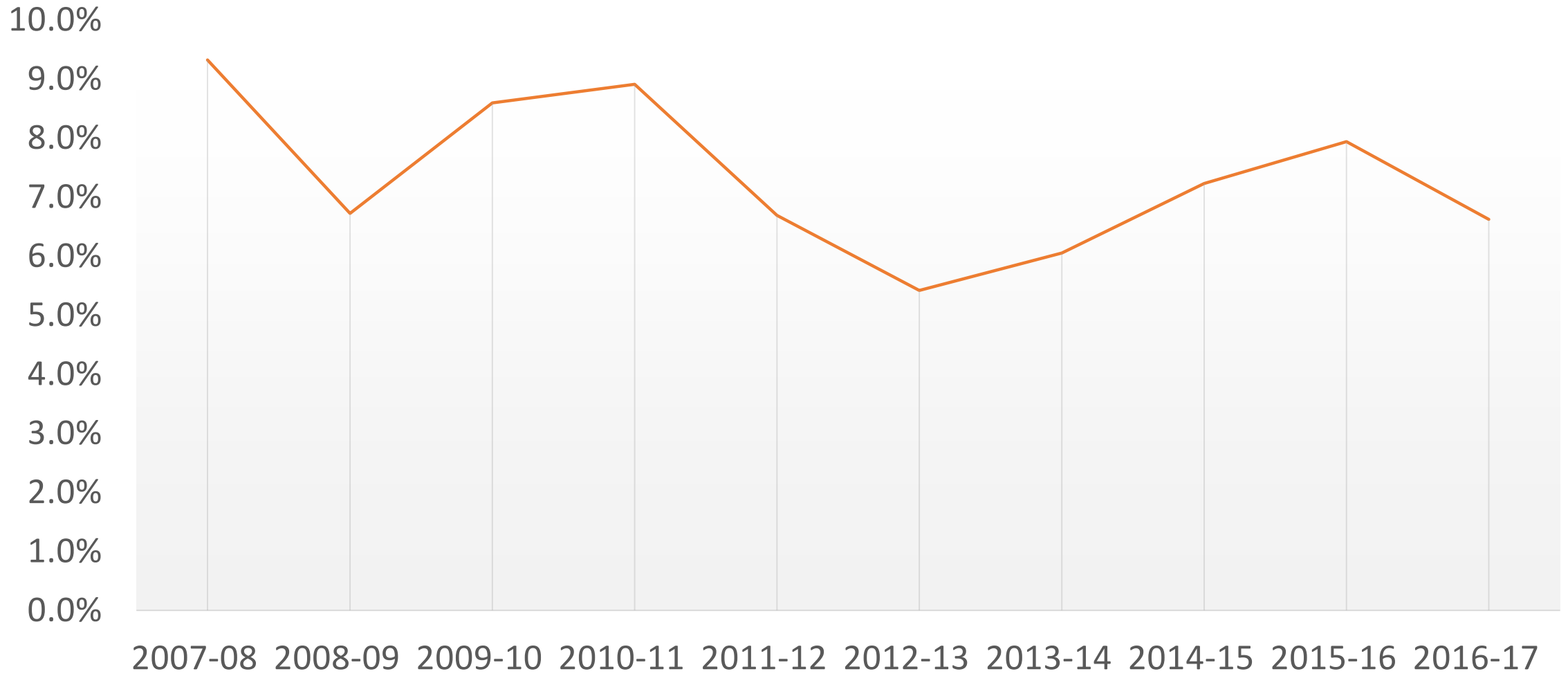


Phase IV (1988-2006) Triumph of liberalisation

GDP growth phase IV 1988 to 2006 – average 6.3%



GDP Growth rate –average 7.6%
Phase V: 2007-16



Phase IV (1988-2006)

- It began with an unprecedented growth spurt and a balance of payment crisis
- In response, India resorted to major liberalisation on domestic and external fronts
- Economy was stabilised, growth at a higher rate resumed within a short period
- If Phase –II is a study of what not to do, phase –IV is a study of what to do correctly
- Every major reform in India is always the result of a crisis!

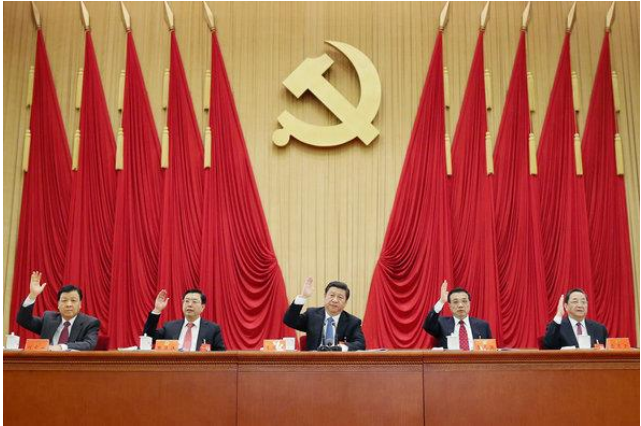
Phase IV (1988-2006): major reforms

- Initial period of rapid growth during 1988-91 followed by macroeconomic (balance of payments) crisis of 1991
 - Large fiscal deficits (around 10 per cent)
 - Large trade deficits
 - Oil price shock : First Gulf war
 - Depletion of international reserves
 - IMF Program + World Bank Structural Adjustment Loan
 - Start of major liberalisation process (1991)



Phase IV (1988-2006)

- Piecemeal reforms of 1980s have given policymakers the confidence that liberalisation would yield results and also politically feasible
- Collapse of soviet union and the spectacular success of China , based on outward oriented policies undermined the view that India could bootstrap its way out of poverty by investment and import controls
- Singapore, Taiwan, South Korea and Hong Kong were always dismissed as too small to compare with India but with China, that argument no longer held



Political Context

- Rajiv Gandhi was succeeded by VP Singh in 1989 who was the face of reforms as Finance Minister in Rajiv Gandhi's cabinet – Chandrasekhar came to power in November , 1990 but lost to Congress in 1991 – PV Narasimha Rao became PM in 1991 – the reform era truly began with Manmohan Singh as Finance Minister – first three years were many reforms were introduced
- Congress lost to BJP in 1996 and Atal Bihari Vajpayee became PM for a short period – Devegowda and IK Gujral were PMs for short periods and BJP came back to power with Vajpayee as PM lasted full five years till 2004 when they lost power to Congress and Manmohan Singh becomes PM in 2004
- India had eight PMs during this period from Rajiv Gandhi to Manmohan Singh, leading coalitions from far left to far right, the reform process kept moving forward – in democracy building consensus and breaking once built are both difficult

The shifting consensus – IG Patel

Even those of us who had actively promoted the earlier policies of 50's and 60's have come to realise that for some time now we have come to underestimate the long term deleterious effects of controls and had not appreciated the potential for a self serving alliance between political leaders and civil servants on one hand and the captains of industry or the large farmers who have sufficient clout both socially and financially on the other. I subscribe to the view that Indian industry must be subjected increasingly to the forces of competition, both internal and international, if it to become more efficient and this requires the Industry to be free from shackles of industrial licencing, import control and other forms of control such as price control exercised ostensibly to overcome regional imbalances or monopoly and restrictive practices or that particular Indian invention viz, concentration of economic power. “



Growth spurt and balance of payment crisis

- During 1988-91, GDP grew at record pace of 10.5%, 6.7% and 5.6%
- The average was 7.6% - agriculture (7%), industry (9.1%) and services (7.1%)
- Agriculture growth increased due to good monsoon and spread of HYV seeds, fertilisers and irrigation
- Industry and services grew due to liberalisation and expansionary fiscal policy combined with foreign borrowing
- The exemption limit of licence free investments was increased from Rs 5 cr to Rs 15 cr in two years – on external front expansion of OGL continued – machinery required for export industry were put in OGL deduction of profits on export sales from taxable income was increased from 50% to 100%
- The gross fixed investment as a proportion of GDP rose from 10.2% in 1986-87 to 13.9% in 1990-91

Growth spurt and balance of payment crisis

- Borrowing abroad and fiscal expansion also happened during this period
- During 1980 to 85, the current account deficit was in the range of 1.3% to 1.9% and it shot up to 3.1% in 1990-91
- Foreign borrowings rose from \$ 20.6 billion 1980-81 to \$ 64.4 billion in 1989-90 ; external debt to GDP went up from 17.7% in 1984-85 to 24.5% in 1989-90 and the debt service ratio increased from 18% to 27% - even though the external debt was helping the economy grow it was moving it towards a crash

Growth spurt and balance of payment crisis

- Defence, interest payments, subsidies and higher wages due to 4th pay revision commission which were 18.6% of GDP in 1980-85 period rose up to 23% of GDP during 1985-90
- Combined fiscal deficits of state and centre went up from 8% in first half of 80's to 10.1% in second half leading to build up of substantial public debt and interest payments accounting for a large portion of government revenues – out come of all these is June 1991 crisis
- The foreign exchange reserves went down from 4.6 months of imports in 1984-87 to 1 month in 1990-91
- In June 1991, with the confidence in the ability of the government completely lost, credit rating was downgraded and India lost access to world financial markets
- For resolving the crisis, a loan from IMF and World bank was taken – structural adjustment loan and India initiated a process of liberalisation

The new industrial policy

- 1991 reforms moved away from controls, licences towards more market based mechanisms
- Statement of industrial policy of 1991 did away with investment licensing and entry restrictions on MRTP firms
- It also ended public sector monopoly in many sectors and initiated automatic approval of FDI up to 51%
- Licensing was now based on a negative list of 18 industries which trimmed down to 5
 - Arms and ammunition
 - Atomic substances
 - Narcotic drugs and hazardous chemicals
 - Distillation and brewing of alcoholic drinks
 - Cigarettes and cigars

Industrial Policy

- Public sector was limited to eight sectors based on security and strategic grounds
- Subsequently only two items remained – railways and atomic energy
- The pre entry scrutiny of investment decisions of MRTP companies was no longer required. They need not obtain approval of the Government for expansion, mergers and acquisitions, appointment of directors etc.
- Foreign investment was also liberalised – concept of automatic approval was introduced – DFI is only prohibited in four sectors
 - Retail trade
 - Atomic energy
 - Lottery business
 - Betting and gambling

Trade liberalization

- July 1991 did away with import licencing on all but handful of intermediate and capital goods – consumer goods remained under licensing which was removed 10 years later
- Today except for a handful of goods disallowed on health, environmental and safety grounds, and few others such as edible oil, fertilizer, petroleum products all goods can be imported
- In 1990-91, the highest tariff rate was 355%, import weighted average rate was 87%
- The top tariff rate was brought down to 85% in 1993-94 and to 50% in 1995-96 and by 2007-8, it has come down to 10% -some exceptions such as automobile at 100%
- Prior to July, 1991 exports of 439 items were subject to control, their number was brought down by 1992 to 296 – at present export controls are only on few items such as cattle, camels, fertilisers, cereals, peanut oil and pulses

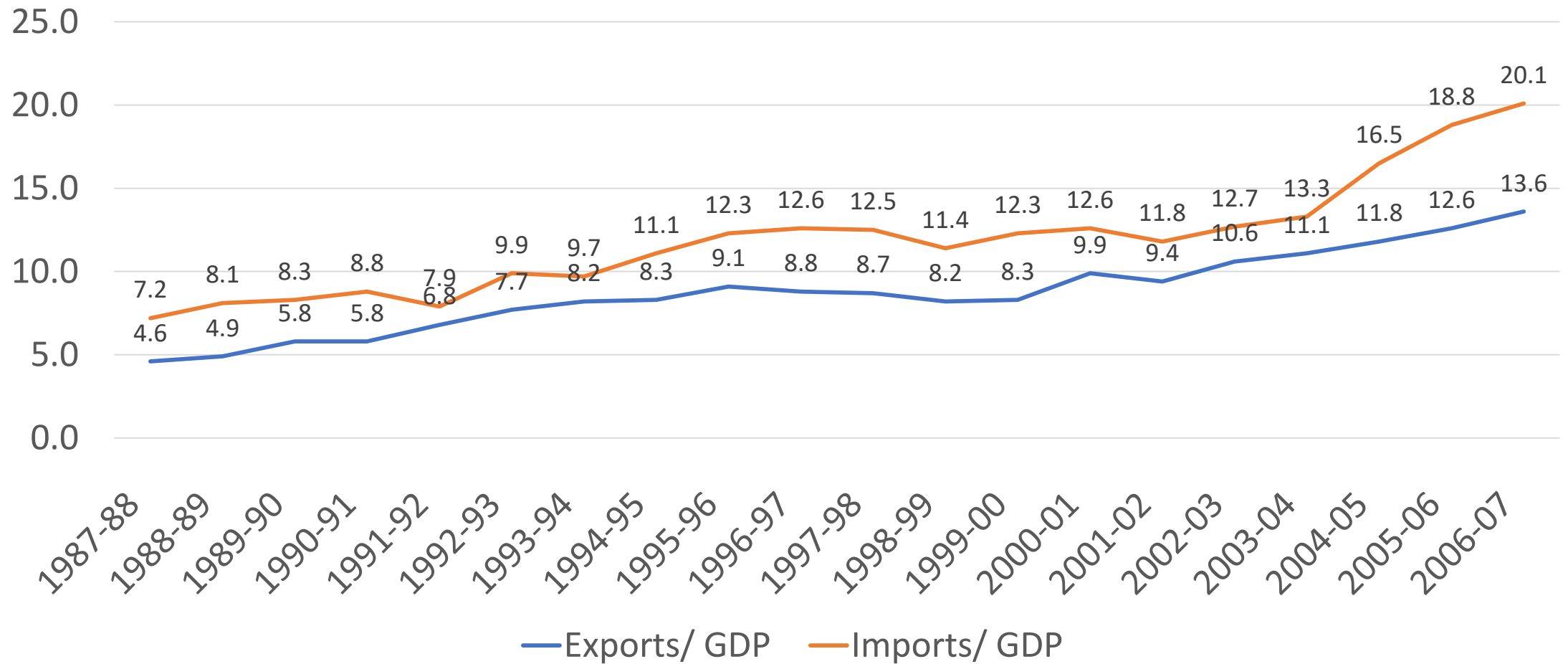
Trade liberalisation- Foreign exchange

- Rupee was devalued by 18% against the dollar
- From 1994 onwards, all current account transactions including business, education, medical and foreign travel were permitted at market exchange rate and rupee became officially convertible on current account
- Even on capital account, residents can remit up to \$250,000 and firms can borrow abroad as long as the tenor is above five years

Tarde in services and foreign investment

- Public sector is dominant in insurance, banking and telecommunication sectors
- Current regime operates on negative list principle i.e., unless specifically prohibited, 100% FDI is allowed under the automatic route
- India has a FDI policy as open as that of China
- Except electronic and print media, all sectors are open
- Key reforms were also introduced in taxation, financial sector, telecommunications, electricity, airline industry and national highway construction
- Rural roads, urban infrastructure and electricity sector continue to struggle

Trade as a % of GDP



Summary

- Phase IV saw the acceleration of growth in GDP, foreign trade and foreign investment
- The GDP growth rate increased to 6.3% compared to 4.8% in the previous phase
- Opening India's economy to world markets and subjecting it to greater competition has been at the heart of India's success
- Growth in trade has been an integral part of India's success

What is unique about India's economic growth?

- India has not grown at superfast rates of 8% to 10% like the miracle economies of east Asia on a sustained basis
- Unlike Africa and Latin American Countries, India has not suffered prolonged periods of decline or stagnation – relatively stable macroeconomically
- In spite of substantial private sector, India pursued inward looking and hugely interventionist industry and trade policies which latter on reversed towards market friendly policies
- India is only one of the four developing countries which is democratic since 1940s

Real and Current GDP



What needs to be done ?
What lies ahead?

Radical reform: rational and setting

- The partial reform model after 1980, especially after 1981
 - deregulation of goods markets and to some extent the financial markets
 - Restrictions on foreign trade and investments were liberalised
 - Licencing was abolished and reservation for hundreds of items for production by small scale sector was scrapped
 - Interest rates were liberalised and government capture of bank credit was reduced
 - Reform has not proceeded far enough and still there are old institutions which are slowing the growth
- If per capita income grows by 7% per annum up to 2040, India would reach a level of \$ 28,000 in today's prices which would place it at the lower levels of high income countries of today such as Greece or Portugal – However such a rapid improvement in productivity over a long period has only a few precedents in history – the partial reform model is not sufficient for such a rapid growth

Agenda for reform

1. Macroeconomic Stability
2. Investment climate
3. Deep Fiscal adjustment
4. Markets, ownership and regulation
5. External economic engagement
6. Social protection and enablement
7. Reform of the state