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SOME CRITICAL ASPECTS ON ECONOMIC REFORMS IN INDIA AND ITS ANALOGY

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Introduction:-

After Independence, the managers of the Indian economy found that the world has been sharply divided into two blocks: the one led by the capitalist economies and other led by the communist economies, primarily the then USSR. There was a cold war between these two blocs. Less developed economies had no option than to join either of the two and invite the ire of the opposite bloc. Especially those economies that were under the British Empire and won freedom during 1940's faced a difficult choice. India chose to keep a safe distance from both the blocks by inventing the idea of a mixed economy. In doing so, India invited as much favor as suspicion from both the blocks. Some economists hold the opinion that the Indian economy was pro-capitalism in its core that wore the façade of a socialistic economy. The state-managed economic endeavors facilitated capital formation in the private sector, often at the cost of the public sector and resources, preparing for a smooth transition to open capitalism in future when the conditions were ripe for such a transition.

Bardhan (1984) has given a vivid picture of this possibility. Nevertheless, the officially proclaimed management policy of the national economy of India was modeled on the socialistic pattern, primarily that of the USSR. It is relevant to note that since the 1970’s, the growth rate of the USSR economy had slowed down substantially. Extensive economic development, based on vast inputs of materials and labor, was no longer possible; yet the productivity of Soviet assets remained low compared with other major industrialized countries. Product quality needed improvement. Soviet leaders faced a fundamental dilemma: the strong central controls of the increasingly conservative bureaucracy that had traditionally guided economic development had failed to respond to the complex demands of industry of a highly developed, modern economy .

Soon after independence, India adopted the path of planned development where the public sector was to play a dominant role in fostering growth at both the central and state levels. The First Five-Year Plan, which was launched in 1950-51, was based on the Harrod-Domar model and primarily concentrated on raising the level of investment in irrigation, power and other infrastructure for accelerating growth. The development strategy was changed radically in 1956 with the initiation of the Nehru-Mahalanobis model of industrial development that emphasized the development of heavy industry under the public sector. Domestic industry was protected from foreign competition through high tariff walls, exchange-rate management, controls and licences. This strategy of import substitution and heavy-industry promotion has been criticized for having created a non-competitive, inefficient, capital-intensive and high-cost industrial structure. It is further argued that this policy discriminated against labour-intensive tradable agriculture and resulted in unwarranted export pessimism because of excessive concern about self-sufficiency. The criticism, however, must be balanced against the fact that during this period India built a large infrastructure not only in heavy and machine goods industries, but also in the areas of power, irrigation, credit, higher education, scientific research and training .The mid-1960s and early 1970s were characterized by serious economic problems. First, because of wars with neighbours, large resources were diverted towards defence, resulting in a sharp decline in public investment that adversely affected the growth of the economy. Second, the foreign exchange situation forced India to devalue its currency

in 1966. Finally, food production failed to keep pace with demand and the country became increasingly dependent on food imports under the United
States Government's PL 480. The situation became critical in the mid-1960s with the failure of two consecutive crops in 1964/65 and 1965/66 and the country had to import large quantities of food-grains under PL 480.
In the late 1960s, agricultural growth revived with the adoption of green revolution technology in some regions. Coincidentally, the manufacturing sector which had seen a notable deceleration in growth from 1964-65 to 1975-76, began registering far higher growth from 1977 to 1978.
During the 1980s, the Indian economy witnessed an unprecedented growth rate of 5.4 percent per annum. The 1980s was also a period when limited liberalization measures were initiated and steps were taken to modernize some of the most important industries, such as cement, steel, aluminium and power generation equipment .
Finally, in addition to the current account deficit, mounting capital account expenditures by the government and public enterprises had to be financed through public borrowing. By 1990, internal debt liabilities had increased to 53 percent of GDP compared with 35 percent in 1980, and interest payments accounted for as much as 24 percent of total government expenditure. In addition, the sources of foreign borrowing underwent some important changes, as soft International Development Association (IDA) and government-to-government loans dried up and high-cost commercial loans from the banks and non-resident Indians had to fill the gap.
As long as the international credibility of India was high, loans were forthcoming and the country could go on living on foreign borrowing. However, the combination of a number of factors, including the sharp rise in import prices of oil and the downgrading of India's credit rating, led to a loss of confidence that resulted in the drying up of short-term credit along with a net outflow of non-resident Indian deposits. Thus, in spite of borrowing from the International Monetary Fund (IMF), the foreign exchange reserves declined.
It was against this background that the new economic policy was introduced. The multilateral agencies such as IMF and the World Bank insisted that the policymakers undertake structural reforms before they agreed to salvage the country from the foreign exchange crisis.

The Indian economy imports about 70% of its oil requirements from international markets. This makes the economy vulnerable to any increases in oil prices in the international markets. However, the oil prices do not affect the economy homogenously. The services sector is far less dependent on oil than the industrial sector. In fact, as most of the growth in the economy is coming from the services sector, the economy and its performance is becoming less vulnerable to oil price fluctuations. Another reason for the oil-price shocks not being fully effective in India is the governments administered pricing policies of oil that diffused the hikes by raising subsidy etc. Figure 5A plots the trends in international oil prices in the past. The obvious shock periods are 1973 to 1974 and 1980, the two shocks that sent the world into a recession. However, 1990 (the first Iraq war) and the period around 1999 also show significant oil price hikes. The industrial growth rates are also plotted for the same year in figure 5A (units on the right hand margin). We find that the industrial growth was low during the first hike during 1973-1974 but the second hike in 1980 does not seem to have any effect. The hike in 1990 coincides with a fall in industrial growth rates but the hikes during 1999 - 2000 again do not seem to have any impact on industrial growth. From all of this, it seems that an oil price hike has very limited impact on the industrial growth rates as well.

EXTERNAL SHOCKS

Oil price shock

The first scenario represents an oil price shock, It has been observed that the price index of oil imports rises by 100% over actual values in 1997 and 1998. Thus, the price index goes up in 1997 from 540 to 1080 and in 1998 from 440 to 880 respectively. The average price during this period jumps by about 50% over 1996. This may be compared to the oil shock in 1979-80 when the corresponding jump was about 125%. Thus it is a plausible shock though not of the extreme nature as the first and second international oil price shocks. The results of the simulation together with the base-run are given in and in 1998 it is assumed to be 880 instead of 440 (base-run value). The row showing '% Change' measures percentage increases in value of variables in shock scenario over base run values. Thus for shock scenario values that are lower than base run values, '% Change' is negative .

It has been indicated during short run there is a small decrease in the growth rate (3 %) as a result of this shock. This fall is largely due to a corresponding fall in the industrial growth rates, with the other sectors contributing much less to this fall. Inflation rises b 15 % as a result of a large rise in industrial inflation, leading to a slightly stagflationary situation. There is no instability to the growth process from the fiscal sector but a significant fall in the foreign exchange reserves as a result of the shock, gives rise to some instability to growth from the external sector. In the long run, the growth falls by 3.4 %, which is slightly larger than the fall in the short run. This indicates that the impact of the shock is pervasive, i.e., the impact does not become weaker in the long run. The fall in the long run growth rate is the result of similar fall in all the sectors. This indicates that the shock has greater long run impact on the growth of the agricultural and tertiary sector. The rise in inflation is more muted and there is no instability from the fiscal or external sectors.

The Economic Situation in 1990-91

The Indian economy had to face many uncertainties in 1990-91. The effects of the political situation at home, and the persistent fiscal imbalances were accentuated by the Gulf crisis which intensified strains on an already weak balance of payments position. It is a measure of the inherent strength of our economy that it withstood the effects of these shocks rather well. It is also a measure of solid gains registered by our economy during the last forty years since independence. Agricultural output and industrial production continued to grow though their sustainability came under serious doubt. It is estimated that the growth of Gross Domestic Product (GDP) in real terms during 1990-91 will be about 5 per cent. However, due to the combined impact of internal and external factors, consumers have been faced with double digit inflation and the economy is faced with a serious balance of payments crisis. On the domestic front, particular significance is attached to medium-term large and persistent fiscal imbalances which have strained the balance of payments situation and accentuated inflationary pressures in the economy. These factors have been sharply exacerbated by the third oil shock and the related dislocations caused by the crisis and the war in the Gulf during 1990-91.

Prices and Price Management

The price situation remained under pressure throughout the year 1990-91 despite a satisfactory monsoon and a bumper crop for the third year in succession. The annual rate of inflation in terms of the Wholesale Price Index (WPI) at 12.1 per cent in 1990-91 was higher than the rate of inflation at 9.1 per cent in 1989-90. The increase in the Consumer Price Index (CPI)for Industrial Workers was much higher at 13.6 per cent during 1990-91 compared with 6.6 per cent during 1989-90. The major concern about inflation during 1990-91 was that it seemed to be concentrated in essential commodities such as foodgrains, vegetables, pulses and edible oils. The WPI for food articles increased by 18.9 per cent during 1990-91 compared with a rise of only 2.1 per cent during 1989-90. However, the prices of manufactured products remained somewhat subdued and the rate of inflation for the manufactured products during 1990-91 was 8.9 per cent compared with 11.1 per cent during 1989-90.

Fiscal and Monetary Policy

Macro-economic imbalances characterized by high fiscal deficits and a growing revenue deficit have continued to remain a major source of concern for the Government during the past few years. These concerns have been compounded by the impact of the Gulf crisis during 1990-91. Aggregate resources of the Central Government including internal and extra budgetary resources of Central Public Enterprises were estimated to increase by 15.0 per cent in 1990-91. Aggregate disbursements, on the other hand, were estimated to increase by 9.4 per cent in 1990-91, thereby indicating some reduction in the relative size of the gap between income and expenditure of the Central Government. This also applies to the combined Budget Estimates (BE) of the Centre, States and Union Territories for 1990-91, which estimated a deficit of Rs. 8,999 crores compared with the Revised Estimates (RE) of Rs. 12,149 crores in 1989-90. Aggregate receipts were estimated to increase by 13.4 per cent while aggregate expenditure was expected to increase by 10.4 per cent.

The External Sector

India's balance of payments situation remained under considerable pressure throughout the Seventh Plan period, despite a buoyant trend in exports. Exports in rupee terms increased by 25.9 per cent in 1987-88, 29.1 per cent in 1988-89 and 36.8 per cent in 1989-90. On the other hand, imports recorded an increase of 10.7 per cent in 1987-88, 26.9 per cent in 1988-89 and 25.4 per cent in 1989-90. The Gulf crisis imposed an additional burden during 1990-91 in the form of a higher POL import bill, a decline in exports, and also a possible decline in the inflows of remittances from the West Asia. In terms of rupees, exports registered a growth of 17.5 per cent in 1990-91, while imports recorded a relatively higher growth at 21.9 per cent. Consequently, the trade deficit increased by 38 per cent from Rs. 7,735 crores during 1989-90 to Rs. 10,644 crores during 1990-91. New invisibles are also estimated to have declined during the year due to a likely fall in the net private transfers on account of the Gulf crisis, a relatively slow growth of tourist traffic and a steady increase in interest payments on past borrowings. In the capital account, net aid disbursements in 1990-91 were higher than that during the previous years. Available information on other items of capital account also confirms the severe strain on the balance of payments.

The crux of the balance of payments problem during the recent years has been the large and persistent trade deficit and the declining capacity of invisibles to finance this deficit. Net invisibles as a percentage to GDP declined from an average of 2.2 per cent during the Sixth Plan to 1 per cent during the Seventh Plan, while the trade deficit as a percentage of GDP declined only marginally from an average of 3.4 per cent to 3.2 per cent over the same period. Consequently, the current account deficit which needs to be financed through capital receipts, increased from an average of 1.3 per cent of GDP in the Sixth Plan to 2.2 per cent of GDP during the Seventh Plan.

During 1990-91 our import bill on oil at Rs. 10,820 crores was 72 per cent higher than that of Rs. 6,273 crores during 1989-90. There was loss in exports to West Asia, particularly

Kuwait and Iraq. There was also a shortfall in the remittances from West Asia because of the crisis and the war in the Gulf. Thus, the balance of payments situation was under great strain throughout the year. Thus despite sizeable borrowings from the IMF in July-September 1990 and January 1991, the level of foreign exchange reserves (excluding Gold and SDR) which was about Rs. 5,050 crores at the beginning of August 1990 dropped to Rs. 4,388 crores by the end of March 1991, and further to Rs. 2,386 crores by the end of June 1991.

To meet the balance of payments problems caused by the Gulf crisis the Government initiated a number of steps. First, measures were taken to reduce the rate of growth of domestic consumption of petroleum products for containing imports of POL. Second, a set of measures were taken to cut Government expenditure, particularly its import and foreign exchange component. Third, restrictions were put on the imports of components, spares and raw materials, particularly in electronics and automobiles. Thirty four items of capital goods and thirteen items of raw materials were shifted from OGL list to the licencing category, and the residual category of imports under OGL comprising unlisted items in the import policy was shifted to the limited permissible list. Fourth, measures were initiated to generate additional exports. Fifth, efforts were made to accelerate the utilization of the authorized but undisbursed external assistance. Sixth, the possibilities of obtaining credits from oil-exporting countries and further deposits from non-resident Indians were also explored. Finally efforts were made to obtain additional finance from bilateral donors and multilateral institutions.

India, which embarked on a programme of structural reforms in June 1991 after four decades of planning, is currently attracting significant attention throughout the world. Its large economy and population, vast natural resources and, above all, its highly educated, skilled and scientific labour force mean that India is destined to play a major role in the community of nations.

With a per caput income of about US$310 in 1994, India is one of the world's low-income countries. Unlike those of most East Asian countries, the economy in India was characterized by slow growth during most of the period since the Second World War. It was only during the 1980s that the GDP growth rate accelerated to 5.4 percent and per caput income grew by 3.3 percent per annum. This decade of high growth was followed in 1990 by one of the severest foreign exchange crises in the history of the country. In response, India initiated radical stabilization measures and a structural adjustment programme in June 1991 .

The genesis and causes of the 1990 crisis

From 1950 to 1980, while the Indian economy was growing at a relatively slow rate of 3.6 percent, domestic investment exceeded domestic savings by only a small margin. The gap could be bridged through foreign borrowing on a small scale. However, during the period 1979 to 1990, when the growth rate of GDP accelerated to 5.4 percent, the gap between savings and investment widened substantially. The need to finance large capital expenditures and imports of machinery and raw materials, including oil, necessitated heavy borrowing from abroad. The result was a cumulative increase in foreign debt and in repayment liability. Foreign debt increased from US$23.5 billion in 1980 to $63.40 billion in 1991. In 1991, nearly 28 percent of total export revenues went to service the debt. The most important reason for the internal savings rate falling increasingly short of investment requirements was the expanding fiscal deficit of the government

which had risen from an average of 6.3 percent of GDP during the Seventh Five-Year Plan to 8.2 percent by 1990-91.

Large fiscal deficits arose for a number of reasons: exorbitant expenditures were incurred by the central government's subsidies of fertilizers, food and exports and by the state governments' of power, transport and irrigation. The inefficient functioning of many of the central and state public sector enterprises further burdened the government budget.

The planning policies in the context of the structural adjustment programme

While studies recognize India's achievements in higher growth and increasing food security to its rising population, the huge fertilizer, irrigation, electricity, credit and consumer food subsidies eventually became unsustainable. At the same time, external trade policies, domestic regulation of agriculture and related policy distortions heavily discriminated against agriculture relative to manufacturing. Moreover, land reform failed to bring about an equitable distribution of land and, as a consequence, very large inequalities continue to exist in the countryside. Finally, the new technologies that were encouraged by the policies and regulations were more appropriate for the richly endowed irrigated regions of India.

Regional inequalities in productivity and income have remained high and in some cases have tended to increase. Agriculturists in general, and small and marginal farmers and landless labourers in particular, remain extremely poor in the less well-endowed regions. The incidence of rural and urban poverty is very high. According to the latest planning commission estimates, in 1987-88, 39 percent of the population in rural areas and 40 percent in urban areas of India were living below the poverty line. As many as 83 million children in India were malnourished in 1991 .

Until recently, while many critics focused their attention on these limitations, the general thrust of agricultural policy within the framework of planning had not been seriously questioned. However, after the new economic policy was introduced in 1991, all aspects of planning and associated macroeconomic policy have come under serious discussion:

- The inward-looking, import substitution development strategy, which was aimed at rapid industrialization, shifted resources from tradable agriculture to industry by turning the terms of trade against agriculture.
- The overvaluation of the exchange rate subsidized imports and adversely affected all exports, especially agricultural exports.
- Most sector-specific policies at all stages of production, consumption and marketing of agricultural produce, worked against agriculture. For example, the price policy was in practice designed primarily to help the consumers. Farmers were generally given low administered prices in the name of helping the urban poor even when they had to pay higher prices for domestically produced inputs because of the protection given to local industry. In addition, a major proportion of the costs of the inefficient functioning of parastatal organizations, such as the Food Corporation of India, were borne by farmers.

While public opinion in India continues to move toward the view that liberalization has been good, that more of it is needed, and that its pace must be accelerated, the view in some scholarly and policy circles has turned skeptical. It is being pointed out that the average annual growth rate of gross domestic product (GDP) hit the 5.6 percent mark in the 1980s, well before the launch of the July 1991 reforms. Alternatively, the growth rate in the 1990s was not much higher. Therefore, liberalization cannot be credited with having made a significant difference to growth in India. Yet the aggregate growth data tells us that the acceleration of economic growth began earlier, in the early or mid-1980s, long before the exchange crisis of 1991 and the shift of the government of Narasimha Rao and Manmohan Singh toward neoliberal economic reforms." DeLong continues: "Thus apparently the policy changes in the mid- and late-1980s under the last governments of the Nehru dynasty were sufficient to start the acceleration of growth, small as those policy reforms appear in retrospect. Would they have just produced a short-lived flash in the pan—a decade or so of fast growth followed by a slowdown— in the absence of the further reforms of the 1990s? My hunch is that the answer is 'yes.' In the absence of the second wave of reforms in the 1990s it is unlikely that the rapid growth of the second half of the 1980s could be sustained. But hard evidence to support such a strong counterfactual judgment is lacking."

J. Bradford DeLong shows that the conventional account of India, which emphasizes the liberalizing reforms of the early 1990s as the turning point, is wrong in many ways. He documents that growth took off not in the 1990s, but in the 1980s. What seems to have set off growth were some relatively minor reforms. Under Rajiv Gandhi, the government made some tentative moves to encourage capital-goods imports, relax industrial regulations, and rationalize the tax system. The consequence was an economic boom incommensurate with the modesty of the reforms. Furthermore, DeLong's back-of-the-envelope calculations suggest that While the documentation below is limited to scholarly writings, many opponents of reforms in the political arena, including some in the Congress party, share this view. the significantly more ambitious reforms of the 1990s actually had a smaller impact on India's long run growth path. DeLong speculates that the change in official attitudes in the 1980s, towards encouraging rather than discouraging entrepreneurial activities and integration into the world economy, and a belief that the rules of the economic game had changed for good may have had a bigger impact on growth than any specific policy reforms."

It is not entirely clear as to what policy message is to be gleaned from this skepticism. Neither DeLong nor Rodrik suggests that the reforms of the 1990s were detrimental to the growth process. DeLong explicitly states that in the absence of the second wave of reforms in the 1990s, it is unlikely that the rapid growth of the second half of the 1980s could have been sustained. Rodrik is more tentative, emphasizing the change in official attitudes about the change in policies, possibly implying that the attitudes having changed for good, growth would have been sustained even without the reforms of the 1990s. This interpretation itself raises two immediate questions: Is there evidence demonstrating that official attitudes changed significantly during the 1980s and if so how was this change conveyed to the public. Most observers of India are likely to question the view that there had been a significant shift in official attitudes in the 1980s. Indirect evidence of the general dominance of the old attitudes can be found in the care Manmohan Singh took in packaging the bold reforms of 1991, describing them as a continuation of the old policies. A careful reader of Singh's historic 1991 budget speech is bound to be struck by the effort he made to draw a close connection between his proposals and the policies initiated by India's first Prime Minister Jawaharlal Nehru and carried forward by his grandson Rajiv Gandhi.

Panagariya (1994), Singh continuously reiterated the usefulness of the past policies in the speech and repeatedly referred to the contributions of Nehru to development, while also recalling the just-assassinated former Prime Minister Rajiv Gandhi's dream of taking India into the twenty-first century.

More directly, commenting on a previous draft of this paper, N.K. Singh who has been directly involved in policymaking in India during the 1980s as well as the 1990s and is currently Member, Planning Commission wrote the following to the author: "I am somewhat intrigued by the statement of Delong & Rodrik stressing change in official attitude over change in policies implying that if attitude changed for good, growth would have been sustained even without reforms in the 1990s. Even today, more than change in policies we are struggling with change in attitude. The first reflex of any observer of Indian economy or potential foreign investor would be that while policies may not be so bad it is the attitude particularly of official ones which becomes the Achilles heel. In fact the 80s and even the 90s have seen far-reaching change in policies which have not translated themselves fully into changes in attitudes. This attitudinal change indeed constitutes a major challenge in our reform agenda."

The Fragilty of Growth in the 1980's

In comparing the performance prior to the July 1991 reforms and that following them, the conventional practice is to draw the line at 1990–91 and thus divide the time period into the decades of 1980s and 1990s. But this division does not accurately reflect the division into periods prior to and following the July 1991 reforms. Indeed, because 1991–92 was the crisis year and the 1991 reforms were a response to rather than the cause of the crisis, the conventional practice creates a serious distortion by including the year 1991–92 into the post- 1991 reform period. The July 1991 reforms and subsequent changes could not have begun to bear fruit prior to 1992–93. Therefore, for the purpose of this study post-1991 reform period is defined to start in 1992–93 and last until the latest year for which data are available, 2002–03. Pre-1991 reform period precedes this period with the starting date left vague at this point. Though it may be argued that the June 1991 crisis was the result of the policies of the pre-1991 reform period and therefore the year 1991–92 legitimately belongs in it, where appropriate.

At the outset, it may be noted that it is difficult to pinpoint the timing of the upward shift in India's growth rate. Thus, in a recent attempt to pinpoint structural breaks in the growth series, Wallack (2003) is able to achieve at best partial success. She finds that with a 90 percent probability the shift in the growth rate of GDP took place between 1973 and 1987. The associated point estimate of the shift, statistically significant at 10 percent level, is 1980. When Wallack replaces GDP by gross national product (GNP), however, the cutoff point with 90 percent probability shifts to the years between 1980 and 1994. The associated point estimate, statistically significant at 10 percent level, now turns out to be 1987.

Wallack (2003, p. 4314) herself is careful to recognize this fragility. Thus, she notes, "Although the evidence for the existence of a break is strong, the data are more ILO (1996). "Wage workers in agriculture: Conditions of employment and work". ambiguous on its exact timing in the early and mid-1980s." 7.6 percent are critical to obtaining an average growth rate during the 1980s that is comparable to the growth rate in 1990s. Second, the variance of growth rates during the 1980s is statistically significantly higher than that in the 1990s. In this sense, growth during the first period was fragile relative to that in the second and, indeed, culminated in the June 1991 crisis.

During this period it was observed that the average annual growth rate during the eleven-year period from 1992–93 to 2002–03. One obvious criterion for defining the pre-1991 reform period or the "1980s" is to select 11 years immediately preceding the post-1991 reform period: 1981–82 to 1991–92. Average annual growth rate during this period is 5.3 percent. If the inclusion of the crisis year, 1991– 92, into this period is objectionable, we can consider the ten-year period between 1981–82 and 1990–91. In this case, the average growth rate rises to 5.7 percent. Either way, growth rates between the 1980s and 1990s are comparable. But consider for a moment annual average growth rates until 1987–88. Indeed, even limiting ourselves to 1981–82 to 1987–88, we get an average growth rate of only 4.8 percent, which is strictly below the growth rate of 4.9 percent achieved during the Fifth Five Year Plan (1974–79). Thus, had it not been for the unusually high growth rate of 7.6 percent during 1988–91, we would not have reason to debate whether the reforms of 1990s made a significant contribution to growth. The implication is that any explanation of growth in the 1980s must explain the exceptionally high growth during 1988–91

The main components of new economic policy

The aim of the new policy was to bring about a realignment of domestic demand with available resources and to initiate changes in supply and production structures with a view to eliminating the external imbalance. The economy was to be liberalized and gradually integrated with the world economy by the dismantling of tariff walls, the protection of foreign direct investment and upgrading the technology of production in various fields. The broad thrusts of the programmes were financial stability, outward-looking policies and deregulation of domestic markets.

The reforms consisted of two components. The short-term immediate stabilization measures focused on correcting the disequilibrium in the foreign exchange market through demand reduction, reforms in trade policy, a reduction in the fiscal deficit and the dismantling of barriers to the free flow of capital. External competitiveness was to be improved through a large nominal depreciation of the exchange rate.

The medium-term structural adjustment programme introduced reforms in fiscal, exchange rate, trade and industrial policy as well as policies concerning the public sector, the financial sector and the capital market. These reforms included elements such as deregulation of prices and investments, changes in the structure of taxation and public expenditure, moderation in wage increases, privatization of public enterprises and greater integration with the world economy.

The adjustment policies introduced were not specific to the agricultural sector, but concerned the entire economy. Nevertheless, keeping in view the importance and predominance of the agricultural sector in the Indian economy, in terms of both income generation and employment and its intimate relationship with other sectors of the economy through input-output and consumption linkages, the macroeconomic and other changes implied in the stabilization and structural adjustment programme had a significant impact on the sector.

Connection to Liberalisation

To appreciate the role of liberalization in stimulating growth in the 1980s, it is useful to begin with a brief historical background on import controls in India. In their pioneering study, Bhagwati and Desai (1970) provide the most comprehensive and systematic documentation of the wide sweep of the interventionist policies that had come to exist by the late 1960s. As they note, general controls on all imports and exports had been present since 1940. After independence in 1947, import controls were relaxed through the expansion of the Open General Licensing (OGL) list in a stop-go fashion, with the First Five Year Plan (1951–56) representing a period of "progressive liberalization" (Bhagwati and Desai, 1970, p. 282). But a foreign exchange crisis in 1956–57 put an end to this phase of liberalization and comprehensive import controls were restored and maintained until 1966. In June that year, under pressure from the World Bank, India devalued the rupee from 4.7 rupees to 7.5 rupees per dollar. The 57.5 percent devaluation was accompanied by some liberalization of import licensing and cuts in import tariffs and export subsidies for approximately a year. But by 1968, intense domestic reaction to the devaluation led India to turn inward with a vengeance. Almost all liberalizing initiatives were reversed and import controls tightened. This regime was consolidated and strengthened in the subsequent years and remained more or less intact until the beginning of a period of phased liberalization in the late 1970s. According to Pursell (1992), the severity of the controls was reflected in a decline in the proportion of non-oil and non-cereals imports in GDP from the low level of 7 percent in 10 In passing, the role of excellent agricultural performance in yielding the high overall growth rates during 1988–91 may also be acknowledged. Whereas the years 1986–87 and 1987–88 were a disaster for agriculture due to bad weather, the subsequent three years, especially 1988–89, proved unusually good. According to the data in the Economic Survey 2002–03, agriculture and allied activities (forestry and logging, fishing, mining and quarrying), which accounted for a little more than one-third of GDP, grew at an annual average rate of 7.3 percent during 1988–91.

Bhagwati and Srinivasan (1975) offer a fascinating political economy analysis of the 1966 devaluation. In a key concluding paragraph on page 153, they note, "The political lesson seems particularly pointed with regard to the use of aid as a means of influencing recipient policy, even if, in some objective sense, the pressure is in the 'right' direction. The Indian experience is also instructive for the political timing of devaluation: foreign pressure to change policies, if brought to bear when a government is weak can be fatal." This is an important lesson in the political economy of reforms. 1957–58 to the even lower level of 3 percent in 1975–76. Since consumer goods imports had been essentially banned, the incidence of this decline was principally borne by machinery, raw material and components. The impact on the pattern of industrialization and efficiency was visible. Pursell (1992, pp. 433–4) offers a vivid description of the costs to the economy in the following words: “During this period, import-substitution policies were followed with little or no regard to costs. They resulted in an extremely diverse industrial structure and high degree of self-sufficiency, but many industries had high production costs. In addition, there was a general problem of poor quality and technological backwardness, which beset even low-cost sectors with comparative advantage such as the textiles, garment, leather goods, many light industries, and primary industries such as cotton.” Pursell (1992, p. 434) continues, “Although import substitution reduced imports of substitute products, this was replaced by increased demand for imported capital equipment and technology and for raw materials not domestically produced or in insufficient quantities. During the 1960s and the first half of the 1970s, the former demand was suppressed by extensive import substitution in the capital goods industries and attempts to indigenize R&D. By about 1976, however, the resulting obsolescence of the capital stock and technology of many industries was becoming apparent, and a steady liberalization of imports of capital equipment and of technology started soon after.” wo factors facilitated the emergence of the liberalization phase. First, as already hinted in the above quote from Pursell (1992), by the mid-1970s, industrialists themselves were beginning to find the strict regime counterproductive and started pressing the government for the relaxation of controls. A domestic lobby in favor of liberalization of imports of raw materials and machinery had come to exist. At the same time, in the case of raw materials and machinery imports that had no import substitutes, there was no counter lobby. Second, improved export performance and remittances from overseas workers in the Middle East had led to the accumulation of a comfortable level of foreign-exchange reserves .

These reserves lent confidence to policymakers and bureaucrats who had lived in the perpetual fear of a balance of payments crisis. Jagdish Bhagwati, who, upon his return from study abroad in the early 1960s, initially shared in the intellectual attitudes that helped India turn inward but quickly changed his mind in light of the realities on the ground, tells an anecdote that aptly captures the deleterious impact protectionist policies had on the quality of the Indian products. In one of the letters to Harry Johnson, written during his tenure at the Indian Statistical Institute in the early 1960s, Bhagwati happened to complain about the craze he observed in India for everything foreign.

In view of the continuing dominance of leftist ideology in India, pre-1991 reforms were introduced quietly and without fanfare. Therefore, the term “liberalization by stealth,” often used to describe them, is fully justified. Yet, this description gives the misleading impression that the reforms were marginal or inconsequential to the growth performance.

Though the process of relaxation of regulation of industry began in the early 1970s and of trade in the late 1970s, the pace of reform picked up significantly only in 1985. Major changes were announced between 1985 and 1988 with the process continuing to move forward thereafter. Indeed, during this latter period, liberalization had begun to take a somewhat activist form. In turn, GDP growth and the external sector registered a dramatic improvement in performance. As already noted, GDP grew at the annual rate of 7.6 percent from 1988–89 to 1990–91. Exports, which had grown annually at a paltry 1.2 percent rate during 1980–85, registered a hefty annual growth of 14.4 percent during 1985–90. Broadly, the reforms of the 1980s, which were largely in place by early 1988, can be divided into five categories. First, the OGL list was steadily expanded. Having disappeared earlier, this list was reintroduced in 1976 with 79 capital goods items on it. The number of capital goods items included in the OGL list expanded steadily reaching 1,007 in April 1987, 1,170 in April 1988, and 1,329 in April 1990. In parallel, intermediate inputs were also placed on the OGL list and their number expanded steadily over the years. Based on the best available information, this number had reached 620 by April 1987 and increased to 949 in April 1988. According to Pursell (1992, p. 441)), ‘imports that were neither canalized not subject to licensing (presumably mainly OGL imports) increased from about 5 percent in 1980–81 to about 30 percent in 1987–88.' The inclusion of an item into the OGL list was usually accompanied by an "exemption," which amounted to a tariff reduction on that item. In almost all cases, the items on the list were machinery or raw materials for which no substitutes were produced at home. As such their contribution to increased productivity was likely to be significant.

The second source of liberalization was the decline in the share of canalized imports. Canalization refers to monopoly rights of the government for the import of certain items. Between 1980–81 and 1986–87, the share of these imports in total imports declined from 67 to 27 percent. Over the same period, canalized non-POL (petroleum, oil and lubricants) imports declined from 44 to 11 percent of the total non-POL imports. This change significantly expanded the room for imports of machinery and raw materials by entrepreneurs.

Third, several export incentives were introduced or expanded, especially after 1985, which helped expand imports directly when imports were tied to exports and indirectly by relaxing the foreign exchange constraint. Replenishment (REP) licenses, which were given to exporters and could be freely traded on the market, directly helped relax the constraints on some imports. Exporters were given REP licenses in amounts that were approximately twice their import needs and thus provided a source of input imports for goods sold in the domestic market. The key distinguishing feature of the REP licenses was that they allowed the holder to import items on the restricted (and therefore those outside of the OGL or canalized) list and had domestic import-competing counterparts. Even though there were limits to the import competition provided through these licenses, as exports expanded the volume of these imports expanded as well. This factor became particularly important during 1985–90 when exports expanded rapidly .

In addition to a substantial widening of the coverage of products available to exporters against replenishment licenses, Joshi and Little (1994, p. 184) list the following export incentives

introduced between 1985–86 and 1989–90, referring to them as the "quasi- Southeast Asian style" reforms:

- In the 1985 budget, 50 percent of business profits attributable to exports were made income tax deductible; in the 1988 budget this concession was extended to 100 percent of export profits.

- The interest rate on export credit was reduced from 12 to 9 percent.

- In October 1986, duty-free imports of capital goods were allowed in selected "thrust" export industries. In April 1988, access for exporters to imported capital goods was increased by widening the list of those available on OGL and by making some capital goods available selectively to exporters without going through "indigenous clearance."

- Exporters were given an assurance that the incentives announced in the export-import policy would not be reduced for a period of three years. The decline in the share of canalized imports was due to increased domestic production of food grains, cotton, and crude oil and reduced world prices of canalized imports such as fertilizers, edible oils, nonferrous metals, and iron and steel. Good weather and discovery of oil were partially behind the increased domestic output of food grains, cotton, and crude oil.

The fourth source of liberalization was a significant relaxation of industrial controls and related reforms. Several steps are worthy of mention:

- Delicensing received a major boost in 1985 with 25 industries delicensed.14 By 1990, this number reached 31. The investment limit below which no industrial license would be required was raised to Rs 500 million in backward areas and Rs. 150 million elsewhere, provided the investments were located in both cases at stipulated minimum distances from urban areas of stipulated sizes. Traditionally, the industrial licensing system had applied to all firms with fixed capital in excess of Rs 3.5 million. There remained 27 major industries subject to licensing regardless of the size and location of investment. These included a number of major industries like coal, large textile units using power, motor vehicles, sugar, steel, and a large number of chemicals. Products subject to Small Scale Industries (SSI) reservation were also off limits though the asset ceiling of firms designated as SSI units was raised from Rs. 2 million to Rs. 3.5 million.

- Broad banding, which allowed firms to switch production between similar production lines such as trucks and cars, was introduced in January 1986 in 28 industry groups. This provision was significantly expanded in the subsequent years and led to increased flexibility in many industries. In some industries, the impact was marginal, however, since a large number of separate product categories remained due to continued industrial licensing in those products.

- In 1986, firms that reached 80 percent capacity utilization in any of the five years preceding 1985 were assured authorization to expand capacity up to 133 percent of the maximum capacity utilization reached in those years.

- Firms that came under the purview of the Monopolies and Restrictive Trade Practices (MRTP) Act were subject to different rules and could not take advantage of the above liberalizing policy changes. To relax the hold of the licensing and capacity constraints on these larger firms, in 1985–86 the asset limit above which firms were subject to MRTP regulations was raised from Rs. 200 million to Rs. 1,000 million. As a result, as many as 90 out of 180 large business houses registered under the MRTP Act were freed from restrictions on growth in established product lines. Requirement of MRTP clearances for 27 industries was waived altogether. MRTP firms in a number of industries were exempt from industrial licensing provided they were located 100 kilometers away from large cities. MRTP firms were allowed to avail themselves of the general delicensing measures in sectors in which they were not considered dominant undertakings. These measures significantly enhanced the freedom of large firms (with assets exceeding Rs. 1,000 million) to enter new products.
- Price and distribution controls on cement and aluminum were entirely abolished.
- There was a major reform of the tax system. The multi-point excise duties were converted into a modified value-added (MODVAT) tax, which enabled manufacturers to deduct excise paid on domestically produced inputs and countervailing duties paid on imported inputs from their excise obligations on output. By 1990, MODVAT came to cover all sub sectors of manufacturing except petroleum products, textiles, and tobacco. This change significantly reduced the taxation of inputs and the associated distortion. In parallel, a more smoothly graduated schedule of excise tax concessions for small-scale-industries (SSI) firms was introduced, which reduced incentives for them to stay small .

The relaxation of industrial controls reinforced the ongoing import liberalization. In the presence of these controls, firms had to have an investment license before they could approach the import-licensing authority for machinery and raw-material imports. For products freed of industrial licensing, this layer of restrictions was removed. More importantly, under industrial licensing, even for products on the OGL list, machinery imports were limited by the approved investment capacity and raw material imports by the requirements implied by the production capacity. With the removal of licensing, this constraint was removed.

The final and perhaps the most important source of external liberalization was a realistic exchange rate. At least during the years of rapid growth, there is strong evidence of nominal depreciation of the rupee correcting the overvaluation of the real exchange rate.

According to the charts provided in Pursell (1992), both the import-weighted and exportweighted real exchange rates depreciated steadily from 1974–75 to 1978–79 with the approximate decline of the former being 30 percent and of the latter 27 percent. It bears reminding that this was also a period of rapid export expansion (see below) and foreign exchange reserves accumulation that paved the way for import liberalization subsequently. The years 1977–79 also registered the hefty average annual GDP growth of 6.5 percent. The real exchange rate appreciated marginally in the following two years, stayed more or less unchanged until 1984–85, and once again depreciated steadily thereafter.

Joshi and Little (1994) attribute a considerable part of the success in export expansion during the second half of the 1980s to the real exchange rate management. Observing that starting in 1986–87, Indian exports grew considerably faster than world trade and as fast as the exports of comparable developing countries, they offer the following assessment (Joshi and Little 1994, Chapter 7, p. 183) "The real exchange rate was again a critical factor as it depreciated by about 30 percent from 1985/86 to 1989/90. Since Indian inflation in this period rose faster than that of its trading partners, a devaluation of the nominal effective exchange rate of about 45 percent was required and achieved. This reflects a considerable change in the official attitude toward exchange rate depreciation. The change had already begun in 1983, but during 1983 and 1984 action was restricted to keeping the real effective exchange rate constant. From 1985 onward exchange rate policy became more active though the fiction of a fixed basket-peg was still

maintained. From a presentational point of view, the sharp devaluation of the U.S. dollar, which began in 1985, helped a great deal. A devaluation of the real effective exchange rate could be secured by keeping the exchange rate of the rupee against the dollar constant, and in fact there was a mild depreciation in terms of the dollar as well. Cabinet approval was sought and obtained to achieve the real effective exchange rate prevailing in 1979. Policymakers recognized that a real exchange rate devaluation was necessary though the terms of trade were modestly improving, because the debt-service burden had increased and a faster growth of imports was to be expected in the wake of industrial and import liberalization. "

Impact of the Reform

The impact of reforms could be seen most clearly on trade flows. Pursell (1992, p. 441) states this succinctly and emphatically, "The available data on imports and import licensing are incomplete, out of date, and often inconsistent. Nevertheless, whichever way they are manipulated, they confirm very substantial and steady import liberalization that occurred after 1977–78 and during 1980s." He goes on to note that imports outside of canalization and licensing (i.e., those mainly on the OGL) increased from 5 percent of total imports in 1980–81 to 30 percent in 1987–88. The share of non-POL imports in the remaining imports increased from 8 percent to 37 percent over the same period. Quite apart from this compositional change, there was considerable expansion of the level of imports during the 1970s and the second half of the 1980s. Increased growth in exports due to the steady depreciation of the real exchange rate and remittances from the overseas workers in the Middle East had begun to relax the balance of payments constraint during the first half of the 1970s, leading to the expansion of non-oil imports at the annual rate of 17.8 percent. This rapid expansion continued during the second half of the 1970s with non-oil imports registering an impressive 15 percent annual growth rate over the ten-year period spanning 1970–79. In contrast, in the subsequent five years when the real exchange rate appreciated slightly and the income growth slowed down, non-oil imports expanded only 7.1 percent per annum.

Again, during 1985–90, they grew by 12.3 percent. Thus, liberalized licensing rules flexibly accommodated the increased demand for imports during the fast-growth periods.

In this context, it may be reiterated that during the 1980s, India was also helped by the discovery of oil and the spread of the Green Revolution, which helped reduce the need for oil and food imports and thus freed up foreign exchange for non-oil, non-food imports. That these developments helped cannot be denied. At the same time, had India not responded by opening up trade and investment rules, the opportunity offered by these developments would have been lost.

The impact of reforms can also be seen in terms of higher industrial growth. Discussing the changes in the domestic industrial policy, Desai (1999, p. 21) noted. "The changes were complex and arbitrary, but they led to an acceleration of industrial growth from 4.5 per cent in 1985–86 to a peak of 10.5 per cent in 1989–90." Industrial growth during 1988–91 at 9.2 percent was particularly high when compared with earlier periods.

According to Goldar and Renganathan (1990), the import penetration ratio in the capital goods sector rose from 11 percent in 1976–77 to 18 percent in 1985–86. This trend appears to have continued subsequently. Malhotra (1992) notes that the incremental capitaloutput ratio, which had reached as high as 6 at times, fell to approximately 4.5 during 1980s. These observations are

consistent with the finding by Joshi and Little (1994) that the productivity of investment increased during the 1980s, especially in private manufacturing .

But more systematically, Chand and Sen (2002) have recently studied the relationship between trade liberalization and productivity in manufacturing using 3-digit industry data spanning 1973–88 econometrically. They took 30 industries, which accounted for 53 percent of gross value added and 45 percent of employment in manufacturing over this period. These industries divide approximately equally among consumer, intermediate, and capital goods. They measure protection by the proportionate wedge between the Indian and U.S. price and estimate total factor productivity growth (TFPG) in the three industry groups averaged over three no overlapping periods: 1974–78, 1979–83 and 1984–88. They then relate this productivity growth to liberalization.

Chand and Sen (2002) did some further tests by pooling their sample and employing fixed-effects estimator to allow for intrinsic differences across industries with respect to the rate of technological progress. Their estimates show that on average one percentage point reduction in the price wedge leads to 0.1 percent rise in the total factor productivity. For the intermediate goods sector, the effect is twice as large. The impact of the liberalization of the intermediate goods sector on productivity turns out to be statistically significant in all of their regressions .

Joshi and Little (1994, Ch. 13) also addressed the issue of the shift in the growth rate. They analyze the years 1960–61 to 1989–90 dividing them into a low-growth period from 1960–61 to 1975–76 and a high-growth period from 1976–77 to 1989–90. Average annual growth rates during these periods were 3.4 and 4.7 percent, respectively, and statistically significantly different from each other at 5 percent level of significance.16 A key finding of Joshi and Little is that increased investment cannot be credited with the increase in the growth rate during 1976–90 over that during 1960–76. To quote them (Joshi and Little, 1994, p. 327): "Public real investment averaged 7.7 percent of GDP in the first period and 9.9 percent in the second period. Private real investment averaged 12.0 percent of GDP in the first period and 11.7 percent in the second period. Thus the whole of the rise in the investment level took place in the public sector (ignoring errors and omissions). However, the rate of growth of public sector GDP declined (from 7.8 to 7.2 percent a year), while that of the private sector rose (from 2.6 to 3.7 percent a year)." 16 In the data used by Joshi and Little, real GDP is measured at 1980–81 prices. As such their growth rates differ from those computed from real GDP measured at 1993–94 prices. Growth rates for the two periods when 1993–94 is the base year are 3.7 and 4.8 percent, respectively.

Joshi and Little find increased demand through fiscal expansion, more efficient use of the existing resources (due to liberalization), and the rise in the real yield of investment in private manufacturing as the principal sources of the shift in the growth rate. Neither Joshi and Little nor Chand and Sen separately analyze the period 1988–91, which is crucial to obtaining comparable growth rates between 1980s and 1990s. Prima facie it would seem that the results of Chand and Sen would hold even more strongly for this period. The reason is that average annual industrial growth of 9.2 percent during 1988–91 was significantly higher than 6.2 percent growth achieved during 1984–88. In view of the fact that private investment as a proportion of GDP did not rise,

the substantially higher growth in industrial output is likely to be the result of increased productivity .

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