



India: A Decade of Economic Liberalization

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Introduction

The strategic objective of Indian policy makers at the outset of independence was the creation of a self-reliant economy and the reduction of the high levels of poverty that existed, all within a democratic political framework. In order to achieve these objectives the authorities steadfastly pursued a Socialist strategy of state-directed, heavy industry based industrialization complemented by an across-the-board import substitution policy, financial repression and complex industrial requirements. Notwithstanding some notable successes, the highly statist and interventionist development policies adhered to during this period of insulation led to a severely distorted production structure. While growth did pick up in the latter half of the 1970s, the Indian economy was generally mired in a vicious circle of low productivity/product obsolescence and slow growth. Not only was the performance of the Indian economy well below the targets set by the planning authorities, the country was left lagging in terms of economic growth and development relative to its East Asian neighbors such as China and Korea which had broadly similar levels of per capita income at the time of India's independence.

Although some tentative steps were taken in 1985 to liberalize and unshackle the economy by delicensing a few industries, these partial and rather ad hoc measures contributed to the creation of severe and unsustainable macroeconomic imbalances in the Indian economy, particularly with regard to escalating fiscal deficits. The imbalances corresponded to a period of severe political instability and uncertainty following three successive minority governments during 1989-91. While the fragilities in the Indian economy were largely homemade, the shock of the 1990 Gulf war was the single factor which "broke the camel's back" as India was brought to the brink of an international default, something that had never occurred in its post-independence history. Faced with a severe balance of payments crisis as foreign exchange reserves plummeted to US\$1 billion in late June 1991, barely sufficient to cover a fortnight worth of imports, India entered into an IMF structural adjustment program. In addition to the conventional expenditure switching and reducing policies, as part of the IMF agreement, a range of far-reaching economic policy reforms was launched in July 1991 in the external, industrial, financial and public sectors.

Given that India's economic liberalization program has been evolutionary (with inevitable hiccups and backtracking in the interim) rather than revolutionary, even a decade may offer too few degrees of freedom to pass definitive judgment on the longer-term prospects of the Indian economy. Nonetheless, considering that India faced virtual bankruptcy in mid 1991, its economic performance since then has been laudable and rather under-appreciated. On the positive side, all indicators reveal the reduction of the anti-export bias has allowed the Indian economy to attain a higher degree of integration with the global economy in the 1990s

compared to previous decades. The Indian economy recovered smartly from the crisis, real GDP growing at an annual average rate of 6.4 percent between 1992 and 1998 (Table 1). Not only was this a marked improvement from India's own past, it was the second highest rate of growth in the world behind China. On the negative side, India remains highly inward looking in comparison to China and its other East Asian neighbors which embraced the multilateral trading system and laid out the welcome mat for FDI much earlier (in the mid to late 1970s and 1980s). Accordingly, while the developing East Asian economies have been able to move rapidly from manufactured labor-intensive commodities, India has largely been left out of the global division of labor, particularly with regard to parts and components (PCAs) production. India's manufactured exports as a whole have remained stagnant when benchmarked against East Asia. It continues to rely on traditional labor-intensive products despite beginning the industrialization process ahead of most of East Asia (Table 2)¹.

India and the Services Sector

India has fared much better in the area of services trade, particularly new and dynamic sectors involving communications technology viz. the Internet, e-commerce and telecommunication sector. This category of services covers a wide range of activities and primarily involves the extensive use of knowledge and information as a vital input in the factor of production, combining the latest developments in electronic and communications technology. Bajpai (2001) has noted that, "(i)nspired by the success of Singapore, several developing countries consider IT as a unique opportunity to leapfrog whole stages of industrial development. Having missed the first two industrial revolutions, they are eager not to miss the third one - the making of the knowledge economy" (p.13)².

The development of the ICT industry in India has been primarily attributable to the software and product services segments which posted an average revenue growth of about 50 to 60 percent annually during the 1990s; from a mere US\$20 million 10 years ago to US\$5.6 billion in 1999-00. Growth of software development has been overwhelmingly market-driven as opposed to being government-led; government intervention has been minimal ("hands off") and largely reactionary. Its expansion has been propelled by an increasing international demand for such skills, mainly from the US market, on the one hand, and India's nurturing of a pool of skilled IT professionals, on the other. The Indian software industry employs some 160,000 professionals and contributes to around 10 percent of India's total merchandise exports. However, despite this rapid growth, India's share in the total global software market is still a mere 1-2 percent³. The fact that India's share in the total global software market is currently miniscule suggests there may be significant scope for future expansion. In view of this, the Indian government has identified the software industry as a major export and growth thrust area.

Despite the foregoing achievements, there can be no room for complacency. Over the years, the growth in the computer software sector has been much more rapid and steady than that of the hardware sector in the IT sector. The development of the hardware sector has been held back by long-standing and severe bottlenecks in infrastructure and supporting facilities and a rather unattractive tax regime. The developing East Asian economies including China have outperformed India in this area. In addition, the diffusion rates across the population have been much slower in India compared to its East Asian counterparts. Thus, while the use of mobile phones, facsimile, cable television and Internet services in India increased

¹ For details see R. Rajan and R. Sen (2001). "Trade Reforms in India Ten Years On: How Has it Fared Compared to its East Asian Neighbors?", CIES Discussion Paper No.0147, University of Adelaide, December.

² N. Bajpai (2001). "Sustaining High Rates of Economic Growth in India", Working Paper No.65, Center for International Development, Harvard University.

³ However, India's shares in other sub-markets are above 10 percent. For instance, India commands an 18 percent market share in the global customized software market.

significantly during 1995-97 compared to earlier periods, it was still far lower on average compared to East Asia. In part, India has lagged behind because of a late recognition of the potential in this sector and a lack of proper policy and institutional framework to encourage the usage of ICT in India in the beginning of the 1990s when the economic reforms were initiated⁴.

India and Foreign Direct Investment (FDI)

It is increasingly recognized that international trade in general but services in particular has been facilitated by FDI since the intangible and simultaneous production and consumption nature of disembodied services requires FDI to be the main mode of delivery of such services across borders to foreign markets. In addition, there is broad agreement that in a *relatively non-distorted domestic policy environment*, FDI fosters growth by promoting greater competition and trade and facilitating a country's overall integration with the global marketplace. For instance, studies have found that FDI has been a major conduit to China's export and overall economic growth.

Prior to 1991, foreign firms were permitted to enter the Indian market only if they possessed technology that was deemed unavailable in India. Foreign equity participation was limited to 40 percent, and entry of foreign investors in general was severely restricted. Almost every aspect of production and marketing was tightly controlled through industrial licensing. The presence of FDI was expectedly negligible until 1990-91. FDI inflows began in earnest only in the last decade as India consciously tried to improve its overall investment policy framework. Several measures to boost FDI were announced in the last few years in particular, including allowing foreign equity participation of up to 100 per cent under the automatic route of RBI (with ceilings on foreign equity) for infrastructure projects, viz. electricity generation, transmission and distribution, construction of roads, ports highways, vehicular tunnels and bridges.

Table 3 summarizes trends in FDI *approved* and *actual* inflows in India since 1991. Note that the figures report the value of equity investments only, since FDI valuation in India is done at *equity investment* and not at *project cost* (in contrast to most of the East Asian countries)⁵. Since the economic reforms in India in July 1991, when India attracted less than US\$ 0.5 billion worth of equity investments, approved FDI inflows in India increased annually to about US\$ 15 billion in 1997⁶. It declined thereafter to about US\$ 8.6 billion by 2000. Overall, India approved nearly US\$ 72 billion worth of FDI since the post-reform period. However, the realization of this approved FDI into actual disbursements has been quite slow; the average realization ratio (i.e. actual inflows-to-approvals) was about 36 percent over the entire period. Thus, the actual levels of FDI investments in the 1990s have averaged only about US\$ 2.5 to US\$ 3 billion annually. One reason for this gap may be due to the type of investment projects involved. "Heavy duty" infrastructural, power and oil refinery-related projects tend by nature to involve much greater gestations periods between being approved and being actually realized. On an annual basis, India's realization ratio has increased significantly from 17 percent in 1991 to between 50 and 60 percent since 1999. This suggests that policy changes directed towards easing the process of FDI approvals do seem to have had some degree of

⁴ This is admittedly a double-edged sword because, as noted, absence of government regulations is what facilitated the development of this area in the first instance. The key is to ensure that government initiatives are constructive rather than onerous and stifling. Admittedly, as with many other developing countries, India's track record as far as this is concerned leaves a lot to be desired. Hitherto, government failures in India appear to have far outweighed market failures.

⁵ Equity investment is about one fifth to one third of total project cost.

⁶ This figure includes total FDI approved by all the three authorities viz. Secretariat for Industrial Approvals (SIA), Foreign Investment Promotion Board (FIPB), and the Reserve Bank of India (RBI) that are designated for clearing FDI proposals by the Government of India.

success in speeding up the implementation process in translating FDI approvals into actual figures.

Inevitably, India's performance with regard to FDI pales when compared to its East Asian neighbors and China in particular. To be sure, between 1990 and 1998, India's FDI to GDP ratio reached about 0.4 percent (nearly a ten-fold increase over 1980-89 period), while its FDI to GDI ratio increased by nearly eight-fold over 1980-89 period to about 1.6 percent. In comparison, China's FDI/GDP ratio soared exponentially to 4.1 percent from less than 1 percent and its FDI as a proportion of domestic investment reached about 10 percent from only 1.4 percent during the 1980-89 period. China has emerged as the single largest recipient of global FDI among all developing economies and the second largest recipient of FDI in the world after the US, with cumulative inflows amounting to more than US\$ 300 billion at the end of 1999. India's FDI levels in the post-reform period in the 1990s (1990-99) were comparable only to those attained by China in the 1980s (1980-89). Cumulative FDI into India between 1992 and 1998 were US\$12bn in equity, while that to China was twenty times as much (US\$240bn)⁷.

Conclusion

Moving forward, while India's "open door" policies ought not be intentionally biased towards foreign investors at the expense of domestic investors, they do not necessarily imply taking a laissez faire attitude towards FDI. The rather listless response by foreign direct investors to the first decade of India's reforms is not inconsistent with the experience of China which experienced an acceleration in FDI flows only after 1986 despite the reforms being initiated in 1979. What is – or at least should be – of more concern to Indian policy makers is the downward trend in the levels of FDI inflows in the last few years. Accordingly, a more proactive approach may be needed to encourage FDI, especially if it is to hope to come close to attaining the stated goal of attracting US\$ 10 billion in actual inflows annually. This effectively implies a quadrupling the level of annual inflows that India currently receives. Recent initiatives such as leveraging on the world class infrastructural and supporting facilities offered by Singapore and promoting the city state as a "gateway" to investing and doing business in India, not unlike the role historically played by Hong Kong vis-à-vis Mainland China, are encouraging steps in the right direction.

⁷ All this being said, official FDI figures to China may be somewhat fictitious and artificially inflated and need to be interpreted with caution. For instance, while Hong Kong has been a major direct investor, part of the investments may be due to "round-tripping" from the mainland as domestic (Chinese) investors try to take advantage of tax and tariff benefits extended to foreign investors. The exaggeration of FDI figures by each region in China may also be done for political-bragging purposes. Nonetheless, the large gap in FDI inflows between these two Asian giants is without doubt.

Table 1
India's growth performance compared to East Asian Countries

	India			China		Indonesia	
	1980-89	1990-98	1992-98	1980-89	1990-98	1980-89	1990-98
GDP at factor cost (constant 1995 US\$ billion)	5.7	5.8	6.7	N.A	10.6	N.A	5.4
GDP at factor cost (current US\$ billion)	5.2	3.8	8.7	N.A	13.0	2.5	-1.7
GDP at market prices (constant 1995 US\$ billion)	5.9	5.6	6.5	9.8	10.8	6.1	4.6
GDP at market prices (current US\$ billion)	5.3	3.7	8.5	6.1	13.2	3.0	-2.4
GDP growth (annual %)	6.0	5.6	6.4	9.4	10.1	6.4	5.3
GDP per capita, PPP (current international \$)	923.2	1732.6	1830.2	793.0	2255.3	1176.4	2537.8

	Korea		Malaysia		Philippines	
	1980-89	1990-98	1980-89	1990-98	1980-89	1990-98
GDP at factor cost (constant 1995 US\$ billion)	9.2	5.4	N.A	N.A	N.A	N.A
GDP at factor cost (current US\$ billion)	15.2	3.1	N.A	N.A	3.8	4.7
GDP at market prices (constant 1995 US\$ billion)	9.0	5.3	5.6	6.4	1.5	2.7
GDP at market prices (current US\$ billion)	15.1	3.0	5.0	6.8	3.1	4.9
GDP growth (annual %)	7.9	5.9	5.8	6.8	2.0	2.7
GDP per capita, PPP (current international \$)	4796.8	12007.9	3622.3	7324.4	2514.8	3372.3

Source: World Bank (2000). World Development Indicators., New York: Oxford University Press.

Table 2
Comparison of External Sector Indicators of India and Selected Developing East Asian Economies

	India		China	
	1980-89	1990-98	1980-89	1990-98
Exports of goods and services (% of GDP)	6.0	9.7	10.4	21.0
Exports of goods and services (annual % growth)	5.3	11.1	19.1	14.9
Share in World Exports	0.5	0.6	1.3	2.4
Share in World Trade	0.6	0.6	1.3	2.2
Manufactures exports (% of merchandise exports)	60.3	65.2	34.0	81.1
Trade (% of GDP)	14.5	21.9	21.5	39.5

	Indonesia		Korea	
	1980-89	1990-98	1980-89	1990-98
Exports of goods and services (% of GDP)	25.9	29.8	35.0	31.4
Exports of goods and services (annual % growth)	2.0	9.2	11.6	13.8
Share in World Exports	0.9	0.9	1.5	2.2
Share in World Trade	0.8	0.8	1.5	2.2
Manufactures exports (% of merchandise exports)	14.3	46.4	91.4	92.6
Trade (% of GDP)	48.1	57.2	69.8	62.9

	Malaysia		Philippines	
	1980-89	1990-98	1980-89	1990-98
Exports of goods and services (% of GDP)	58.2	89.0	24.7	37.0
Exports of goods and services (annual % growth)	9.6	11.9	7.9	7.9
Share in World Exports	0.7	1.2	0.3	0.3
Share in World Trade	0.7	1.2	0.3	0.4
Manufactures exports (% of merchandise exports)	31.0	70.0	27.7	59.7
Trade (% of GDP)	113.9	176.1	51.0	80.6

Source: World Bank (2000). World Development Indicators., New York: Oxford University Press.

Table 3***FDI Inflows to India in the Last Decade***

	Total Approved equity Investments (US \$ billion)	Total Actual equity investments (US \$ billion)	FDI Realization ratio (Actual/Approved FDI) (%)
1991	0.22	0.14	65.80
1992	1.49	0.26	17.37
1993	2.89	0.58	20.17
1994	4.52	1.05	23.18
1995	10.21	2.17	21.26
1996	10.51	3.02	28.74
1997	15.30	4.58	29.92
1998	7.80	3.38	43.29
1999	6.75	4.02	59.46
2000	8.61	4.50	52.22
2001*	4.09	2.16	52.81
Cumulative (1991-2001*)	72.40	25.86	35.72

* Upto July 2001

Source: Calculated from SIA Newsletter, various issues