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India's Prevailing Political Economy: The Logic of Reform

Amb. Hemant Krishan Singh

24 July, 2011 marked the 20th anniversary of India's historic economic reforms. In the midst of challenges posed by civil society on matters of corruption, the occasion passed without fanfare, generating only some sober reflections on the headwinds facing the economy. It would be fair to say that India's economic policy and performance increasingly appear to be on autopilot, powering ahead on its own rather than being buttressed by a strong government policy framework. Let us try to sift through the prevailing mood and outline the trends going forward.

July 1991 marked the most significant turning point in India's political economy. Largely with one "big bang" reform moment, the burden of State control over the productive capacities and enterprise of the Indian people was lifted. The sheer scale of change was unprecedented, covering as it did the liberalization and reform of trade, tariffs, exchange rate, industry, financial markets and taxes. India's doors were opened to foreign investment in many sectors.

It is significant that this reform process has been unidirectional, no matter which political dispensation has been in power. Ownership over the reforms has been bipartisan, providing for lasting democratic stability. There has been no turning back.

As a result, with GDP growth averaging around 7% over the past two decades, India's economic landscape has been transformed, with more progress on lifting millions out of poverty than in the preceding 40 years. A growing middle class of 300 million has emerged.

Remarkably, the key drivers of the economy have been domestic: rising savings and investment, private enterprise, consumption and globally competitive corporations.

As pointed out by Dr. Shankar Acharya, Honorary Professor at ICRIER[1], the period 2003-2008 marked the best sequential five years of macroeconomic performance that India has ever witnessed. From 2005-2008, India recorded 9.5% annual GDP growth.

When the present government took up its second term in 2009, there was widespread expectation that reforms would gain impetus. Instead, the government's magic formula - pursuing both "social equity" and "economic efficiency" – started to weaken. The focus veered increasingly towards building social welfare programmes through legal entitlements (right to information, employment, education and food), creating burdensome dependencies instead of empowering the economy with more growth and jobs. Resort to statist measures made a comeback. Mega projects remained stalled, dampening investor sentiment and hurting the real economy. Public sector reform has remained virtually shelved since 2004. There have been no strategic sales; equity divestments have been limited. Air India is only the most glaring example of this constant drain on the exchequer.

The Indian economy was surprisingly resilient after the global financial meltdown of 2008. However, it has not bounced back to 2003-2008 levels on any performance indicator

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reflecting, partly, the contagion from adverse global developments.

India's Macroeconomic Performance before and after Global Crisis

	Before 2005-08	After I 2008-11	After II 2009-11	Projected 2011/12*
Economic Growth (% per year)	9.5	7.8	8.3	7.0-7.5
Inflation (GDP deflator, % per year)	5.5	8.4	8.7	7-8
Current Account Deficit (% of GDP)	1.2	2.5	2.7	2.5-3.0
Combined Fiscal Deficit (% of GDP)	5.3	8.5	8.5	7.5-8.0
Gross Domestic Investment (% of GDP)	36.1	35.3	35.3	33-35
Gross Fixed Investment (% of GDP)	31.5	30.8	30.2	28-30

*Projections by Dr. Shankar Acharya   Sources: CSO and RBI

In his comparative study[1] of pre (2005-2008) and post (2008-11) financial crisis indicators, Dr. Acharya has concluded that there has been a clear worsening of India's macroeconomic performance on every front: slower growth, much higher inflation, doubling of the external current account deficit, a combined (centre and states) fiscal deficit that is 60% higher, and a slight fall in the rate of domestic investment. Today, exports are about the only sector recording strong growth (+52.1% in April-September 2011), but it remains vulnerable to volatility in external demand. Balance of economic data is not reassuring: industrial production is subdued, headline inflation is over 9% with food inflation even higher, auto sales are slumping, the stock markets are in distress and the rupee has slipped 10% in the past two months. Meanwhile, the Reserve Bank has no option but to target aggregate demand with monetary tightening till price stability is achieved. Higher interest rates and infrastructure bottlenecks are constricting the economy.

There are multiple factors behind this slowdown, but one major aspect appears to be the Government's inaction on reforms, as well as poor governance. Wealth creation cannot be sustained without conditions that facilitate enterprise and investment. We are learning that economic growth is not ordained and its future trajectory is dependent on productivity enhancing reforms. Meanwhile, Indian Corporations are finding it more beneficial to invest abroad, reflecting higher returns and fewer constraints for conducting business.

Some Indian companies are also under the scanner for a range of anomalies. This has led to concerns about crony capitalism and misguided criticism of economic liberalization itself. A group of 14 eminent business leaders and public figures have recently written to the Prime Minister, urging a raft of reform measures and transparency in decision making. The Government would do well to recognize that the sagging economy corresponds to an adverse business-policy framework and absence of reform, and the blame cannot rest on scams alone.

The Government's apparent lack of ambition may be compensated by a new stakeholder. Indian society and its surging middle class would like to see faster and wider progress in living standards through accelerated reform.

Looming economic bankruptcy had triggered the 1991 reforms. Today, India's economy faces no such threat but we appear to have reached another critical juncture. A slight moderation is helping to refocus attention on Stage-II reforms. These will broadly need to include the following:

- Institutional reform of governance to ensure accountability, transparency and predictability, in line with the pace of economic transformation.
- Continued emphasis on physical infrastructure, particularly power, roads and ports, with projected infrastructure investments of US $ 1 trillion or 10% of GDP during the 12th Plan (2012-2017).
- Land acquisition reform to remove a major constraint to infrastructure, industry and urbanization.
- Reform of environmental and regulatory frameworks hampering extractive industries, particularly coal.
- Stage-II liberalization covering multi-brand retailing, banking, insurance, capital markets, pension, postal services and defence production.
- Pricing reforms to remove inefficiencies in power, water, food, petroleum and fertilizers, which remain a major drain on the economy.
- Labour market reform to promote organized sector employment and create flexibilities for seasonal demand and contractual labour.
- Demographic dividend-linked reforms to provide quality education and skill development on a mass scale, with emphasis on "employability".
- Completion of taxation reforms with a Direct Tax Code and a single nationwide Goods and Services Tax (GST).

Legislation on some of these reforms has been introduced or is in the process of being brought before Parliament. There is unlikely to be a big bang approach towards Stage-II reforms, which are expected to be incremental. However, if the Government gets past its recent record of inaction and fast tracks these reforms, efficiency gains could make it possible for the Indian economy to rebound to higher levels of sustainable growth in a couple of years. In the meanwhile, GDP growth will come down from the 8.5% recorded in 2010-11 to between 7-8% in 2011-12. It remains to be seen if inflation will come down to more acceptable levels by next year. Without reform, we may even slip back to the lower growth rates of the 1990s, especially as the global economy is under renewed stress.

While this is a realistic picture, the fundamental strengths of the Indian economy remain intact: domestic savings, investment, consumption and enterprise. As *The Economist*[2] has pointed out, more workers from India's demography and capital from rising savings account for half of recent growth rates of about 8%; the paper also cites a recent OECD study which put this proportion at three quarters. Exports are booming, thanks to competitiveness and diversification. Having doubled in the last four years to $ 250 billion, they are projected to double again in the next three to reach $ 500 billion. Given the right conditions, manufacturing industry is set to grow. Some states are powering ahead at over 11% growth; even so-called backward states are making progress. India's debt is around 66% of GDP[2], mostly domestically held, and is falling. However, while public debt does not pose an immediate problem, private sector MNC external debt could face difficulties with a rapidly depreciating Indian rupee.

Even a comparison with China is useful to illustrate the India advantage. A gross domestic investment rate of 35.3% in India has delivered 8.3% GDP growth in 2009-2011[1]. The 9% + growth of the Chinese economy in 2010 derived 54% from investment and only 37% from consumption, as has been pointed out by Prof. Minxin Pei[3]. India still generates more output with less and remains a healthier consumption driven economy.

With the US economy displaying Japan-like symptoms of a liquidity trap (high indebtedness and low growth), and with Europe's snowballing sovereign debt crisis, we are witnessing a worldwide economic outlook that is far from a revival. India's globalized economy cannot remain unaffected. Depressed demand in the US and Europe will put downward pressure on exports, and any further quantitative easing in mature economies will raise inflationary concerns at home. In such a global environment, the Government appears to be behind the curve on reform and has to step up to the plate with some determination.

Dr. Parthasarathy Shome, Director of ICRIER, has suggested[4] that as the Cannes G-20 Summit (3-4 November, 2011) approaches, there is an opportunity for India and other BRICS countries to do some out of the box thinking and adopt a common position over remaining aspects of liberalisation of their economies, an issue that advanced economies harp on during less stressed circumstances. In the case of India in particular, he points out that financial sector liberalisation, including banking and insurance, would help buttress supply opportunities for mature economies, improve the allocative efficiency of investment, and reduce expenditure through a scaling back of global demand for their government securities.

In a similar vein, Dr. Shome suggests that liberalising the retail sector would help advanced country firms find a new source of unmet demand and improve their global supply chain. This would, in turn, rationalize the cost of production and enhance net exports of these economies. That would act as a catalyst in reviving global demand. In the process, BRICS, and India in particular, would reap the benefit of organized retailing, investment in local supply-chain management and storage capacity, areas in which improvement is required immediately. An efficient service sector would make a better enabling environment for more foreign investment, thus engendering a second round of correction in global imbalances. Making a contribution towards redressing global imbalances through domestic policy reform, rather than through making a token contribution of financial resources that can at best represent a drop in the bucket, would be a more proactive, albeit deeper and more challenging, route for India and its BRICS partners to adopt[4].

Prime Minister Dr. Manmohan Singh, the author of the 1991 reforms, has often said that India's growth is not an end in itself and must be oriented towards inclusiveness. It is entirely reasonable to hold that growth is not just a number, but it must equally reflect India's true potential. The "idea whose time has come" which Dr. Singh referred to in 1991 was no less than India's emergence as a "major economic power in the world". It is time to press the pedal on Stage II economic reforms and provide fresh momentum to growth which has brought unprecedented progress to the Indian people over the last two decades.

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- ***Amb. Hemant Krishan Singh holds the ICRIER - Wadhwani Chair in India – US Policy Studies***

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