

India's Economic Reforms

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The past three years have seen major changes in India's economic policies marking a new phase in India's development strategy. The broad thrust of the new policies is not very different from the changes being implemented in other developing countries and also all over the erstwhile socialist world. They aim at reducing the extent of Government controls over various aspects of the domestic economy, increasing the role of the private sector, redirecting scarce public sector resources to areas where the private sector is unlikely to enter, and opening up the economy to trade and foreign investment.

These changes have been accompanied by a lively debate in India and have also attracted interest abroad. International opinion has typically welcomed the reforms and generally urged a much faster pace of implementation, especially in view of changes taking place in other countries. Within India, opinion has been more varied. There are some who question the very direction of reform, but this is definitely a minority opinion. More generally, the broad direction of reform has met with wide approval, but there are differences of view on what should be the pace and sequencing of reforms. While there is widespread support for the elimination of bureaucratic controls over domestic producers, there are differences on such issues as the speed at which protection to domestic industry should be reduced, the extent to which domestic industry can be subjected to foreign competition without being freed from the currently prevalent rigidities in the domestic labour market; the extent to which privatisation should be pursued etc. These are obviously critical issues in designing a reform programme. They become particularly important when all the elements of an optimal package cannot be fully implemented simultaneously owing to social or political constraints. This confronts reformers with typical "second best" problems since the infeasibility of one element of the package could make pursuit of other elements anfractuous even counter-productive. The recently developed literature on the sequencing of reform in developing countries provides some guidance in making these difficult choices though it is far from being conclusive.¹

This paper presents an overview of what has been achieved in India's current reforms. It indicates some of the compulsions affecting the sequencing and pace of reforms and attempts to evaluate the internal consistency of the resulting package. The paper also presents a tentative assessment of the results achieved at the end of the third year.

I. A Gradualist Approach

An important feature of India's reform programme, when compared with reforms underway in many other countries, is that it has emphasised gradualism and evolutionary transition rather than rapid restructuring or "shock therapy". This gradualism has often been the subject of unfavourable comment by the more impatient advocates of reform both inside and outside the country. Before considering the contents and design of the Indian reform programme, it is useful to review some of the main reasons why India's reforms have followed a gradualist path.

One reason for gradualism is simply that the reforms were not introduced in the background of a prolonged economic crisis or system collapse of the type which would have created a widespread desire for, and willingness to accept, radical restructuring. The reforms were introduced in June 1991 in the wake a balance of payments crisis which was certainly severe. However, it was not a prolonged crisis with a long period of non-performance. On the contrary, the crisis erupted suddenly at the end of a period of apparently healthy growth in the 1980s, when the Indian economy grew at about 5.5% per year on average. This may appear modest by East Asian standards, but it was much better than India's previous

* This paper is based on the author's address inaugurating the Seminar on India's Economic Reforms at Merton College, Oxford, June 1993 updated to include developments upto March 1994.

¹ For a review of this literature see Edwards (1989) and Funke (1993).

experience of 3.5 to 4% growth and was also better than the average growth rate of all developing countries taken together in the same period.

Not only did economic performance improve in the eighties, this improvement was itself perceived to be the result of a process of evolutionary reform. By the beginning of the decade of the eighties it began to be recognised that the system of controls, with a heavy dependence on the public sector and a highly protected inward oriented type of industrialisation, could not deliver rapid growth in an increasingly competitive world environment. The sustained superior performance of East Asian countries was evident to all by the mid-eighties, and this helped create a perception that India could and should do better, but the approach remained one of evolutionary change. Several initiatives were taken in the second half of eighties to mitigate the rigours of the control regime, lower direct tax rates, expand the role of the private sector, and liberalise licensing controls on both trade and foreign investment. However, these changes were marginal rather than fundamental in nature amounting more to loosening controls and operating them more flexibly rather than a comprehensive shift away from a regime of controls. Since the economy was seen to have responded well to these initiatives, with an acceleration in growth in the 1980s, it created a strong presumption in favour of evolutionary change.

Finally, gradualism was the inevitable outcome of India's democratic and highly pluralistic polity in which economic reforms can be implemented only if they are based on a sufficiently wide popular consensus. The favourable experience of liberalisation in the 1980s had created an intellectual climate for continuing in the same direction, and the crisis of 1991 certainly "concentrated the mind" in favour of bolder reforms, but the pace of reforms had to be calibrated to what would be acceptable in a democratic polity.² This consideration was all the more important in June 1991 since the new Government did not at that time have a majority in Parliament.

II. The Scope and Coverage of the Reforms

The reform programme initiated in June 1991, though gradualist in its approach, was nevertheless very different from the incremental approach to reforms of the 1980s. As far as objectives are concerned, the current reforms are based on a much clearer recognition of the need to integrate with the global economy through trade, investment and technology flows and for this purpose to create conditions which would give Indian entrepreneurs an environment broadly comparable to that in other developing countries, and to do this within the space of four to five years. As far as instruments are concerned, there is clear recognition that the reforms cannot be limited to piecemeal adjustments in one or other aspect of policy but must bring about system changes affecting several sectors of the economy. The comprehensiveness of the reforms was not perhaps fully evident at the very beginning, when the primary focus was on restoring macro-economic stability, but as the reforms proceeded the scope and coverage of the reform effort was more clearly outlined. The main elements of the reform are summarised in this section, which also indicates differences in the pace and sequencing of individual elements in the package.

i) Fiscal Stabilisation

If the recent literature on sequencing of reforms yields one firm conclusion it is that fiscal stabilisation is an essential precondition for the success of economic reforms. The design of India's reform programme was fully in line with this conclusion and fiscal stabilisation was given the highest priority, especially in the initial phase of crisis management when the current account deficit was high and inflation in double digits.

The Central Government fiscal deficit had expanded steadily during the eighties and had reached a peak level of 8.4% of GDP in 1990-91. Allowing for deficits of the State Governments, this meant an overall Government fiscal deficit of around 10% which is high

² Interestingly the earliest reference typically cited in the literature on sequencing is Little Seitovsky and Scott (1970) in which gradualism is favoured precisely on the grounds that it was less likely to generate coalitions of strong opponents.

by any standard. A reduction in the Central Government's fiscal deficit was therefore critical for the reforms to take off. The first year of the reforms saw a substantial reduction in the Central Government fiscal deficit from 8.4% of the GDP in 1990-91 to 5.9% in 1991-92 and further to 5.7% in 1992-93. Some of the reduction in the fiscal deficit in the first two years was achieved by systemic improvements which permanently strengthened the fiscal situation, such as for example the abolition of export subsidies in 1991-92 and the partial restructuring of fertiliser subsidy in 1992-93. Another important systems change was the announcement that budget support to loss making public sector units in the form of Government loans to cover their losses would be progressively phased out. However part of the fiscal adjustment in the first two years was also achieved by restricting development expenditure, including expenditure on social and economic infrastructure. Despite this limitation, the success achieved in fiscal consolidation in the first two years was commendable, with the fiscal deficit being reduced by 2.7 percentage points of GDP. In this respect the management of reforms in the first two years was entirely in line with the prevailing consensus on sequencing.

The process of fiscal consolidation was to continue into the third year of the reform with the fiscal deficit expected to be reduced to 4.6% of GDP in 1993-94. In the event, there was a substantial slippage from this target and the fiscal deficit in 1993-94 is estimated at 7.3% of GDP. Part of the slippage (about 1 percentage point of GDP) was due to a shortfall in tax revenues compared to Budget targets. Customs revenues were substantially below the target because imports were much lower than expected, despite significant reductions in customs duty rates and liberalisation of imports implemented as part of the structural reform (see below). Excise duty collections also fell short because industrial production did not recover as rapidly as expected. The rest of the slippage (about 1.7 percentage points of GDP) was due to expenditures exceeding targets. Delays in adjusting food prices in the public distribution system led to higher food subsidy and expenditures on development were higher than projected partly because of larger flows of resources to support development expenditure of the States. To some extent the overshooting of expenditures reflects pent up pressures, which had built up over two years of fiscal consolidation and were difficult to resist.

It is also true that the overshooting of expenditure in 1993-94 was to some extent tolerated in 1993-94 because the economy was suffering from underutilisation of capacity. Public sector investment, especially by the States, was held back by fiscal constraints and private sector investment was also restrained as the corporate sector re-adjusted its investment plans in line with the new, much more competitive economic environment. The prevalence of excess capacity in parts of the economy, combined with a surprisingly easy external payments position, and a sharp reduction in inflation to less than 6% in mid-1993 led to a willingness to accept a more expansionary fiscal policy.

The unexpected increase in the fiscal deficit in 1993- 94 is understandably a cause of considerable concern among observers of the reform programme. Experience in many developing countries provides several examples of reform efforts which have been aborted by premature easing of fiscal control. The Government has recognised this problem and has indicated that the deviation from the path of fiscal consolidation in 1993-94 was a temporary phenomenon and will be reversed in 1994-95. Accordingly, the target for the fiscal deficit in 1994-95 has been set at 6 per cent of GDP, which is a significant improvement over the actual performance in 1993-94.

An important new initiative in the 1994-95 Budget is the announcement that there will be a pre-determined cap on the extent of monetisation of the Government deficit which did not exist earlier since the Government could borrow from the Reserve Bank without limit. It is now proposed to operate a ceiling on Government borrowing from the Reserve Bank by authorising the Reserve Bank to auction Treasury Bills at market rates whenever the pre-determined ceiling is breached for more than a specified period.

ii) Industrial Policy and Foreign Investment

Perhaps the most radical changes implemented in the reform package have been in the area of Industrial Policy removing several barriers to entry in the earlier environment. The system

of pervasive industrial licensing prevalent earlier, which required Government permission for new investments as well as for substantial expansion of existing capacity, has been virtually abolished. Licensing is now needed only for a small list of industries, most of which remain subject to licensing primarily because of environmental and pollution considerations. The parallel but separate controls over investment and expansion by large industrial houses through the Monopolies and Restrictive Trade Practices (MRTP) Act have also been eliminated. The many inefficiencies of this system - carefully documented by Bhagwati and Desai as early as 1970 - are now truly a part of history as far as the Central Government is concerned. A comprehensive restructuring of the Companies Act is also underway which aims at simplifying and modernising this aspect of the legal framework governing the corporate sector.

One area where licensing controls remain in place relates to the list of industries reserved for the small scale sector. Doubts are often expressed on whether reservation, which prevents larger units from entering the reserved areas to compete with small scale industries, is a desirable instrument for promoting the small scale sector. However the Government has indicated that the general policy of reserving certain items for the small scale sector will continue for social reasons. This restriction may not be very significant in practice since the areas reserved in this way are actually quite small. The major problem really arises in certain product areas which are reserved for the small scale sector but which also have a substantial export potential such as for example toys and "garments. In order to introduce a measure of flexibility in such cases, the Government has modified policy to allow medium scale units to enter such areas provided they export at least 50% of production.

The list of industries reserved for the public sector has been drastically pruned and many critical areas have been opened up to private sector participation. Electric power generation has been opened up for private investment, including foreign investment, and several State Governments are actively negotiating with various foreign investors for establishing private sector power plants. The hydrocarbon sector, covering petroleum exploration, production and refining has also been opened up to the private sector including foreign investment and has attracted significant investor interest. Air transport, which until recently was a public sector monopoly, has been opened up to the private sector and some new entrants have begun operations. The Telecommunication sector has also been opened up for certain services such as cellular telephones, though the modalities for inducting private sector participants have yet to be worked out.

The liberalisation of controls over domestic investors has been accompanied by a radical restructuring of the policy towards foreign investment. Earlier, India's policy towards foreign investment was selective and was widely perceived by foreign investors as being unfriendly. The percentage of equity allowed to foreign investors was generally restricted to a maximum of 40%, except in certain high technology areas, and foreign investment was generally discouraged in the consumer goods sector unless accompanied by strong export commitments. The new policy is much more actively supportive of foreign investment in a wide range of activities. Permission is automatically granted for foreign equity investment upto 51% in a large list of 34 industries. For proposals involving foreign equity beyond 51%, or for investments in industries outside the list, applications are processed by a high level Foreign Investment Promotion Board. The Board has established a record of speedy clearance of applications and the total volume of foreign equity approved in the first 24 months amounts to \$3 billion. This compares with annual levels of approvals of only about \$150 million only a few years earlier. Various restrictions earlier applied on the operation of companies with foreign equity of 40% or more have been eliminated by amendment of the Foreign Exchange Regulation Act and all companies incorporated in India are now treated alike, irrespective of the level of foreign equity.

India has joined the Multilateral Investment Guarantee Agency (MIGA) and has recently concluded a bilateral Investment Protection Agreement with the United Kingdom. Similar bilateral agreements are being negotiated with other major investing countries.

iii) Trade and Exchange Rate Policy

In keeping with the objective of greater openness and outward orientation, trade policy has

been very substantially liberalised for all except final consumer goods. The complex import control regime earlier applicable to imports of raw materials, other inputs into production and capital goods has been virtually dismantled. Today, all raw materials, other inputs and capital goods, can be freely imported except for a relatively small negative list. Imports of consumer goods remain restricted except for the limited windows of permissible imports of such items by returning Indians and a limited facility for imports of some consumer goods allowed against special import licenses which are given to certain categories of exporters as an incentive. The exclusion of consumer goods from trade liberalisation is an important restrictive element in trade policy - and the Government has indicated that this too will be gradually liberalised - but for all other sectors quantitative restrictions on imports have been largely eliminated.

The removal of quantitative restrictions on imports has been accompanied by a gradual lowering of customs duties. India's customs duties before the reforms were very high, with the average rate of duty being as high as 100% and very substantial variations around this average. The Government has made a series of downward adjustments in customs duties in each of the four Budgets since 1991. The peak rate of customs duty applicable to several items was over 200% in 1991. It has been lowered to 65% in 1994. Other customs duty rates below the peak have also been lowered, especially the duties on capital goods. The rate of customs duty on capital goods used to be as high as 90-100% in 1991 with concessional duty imports of capital goods available only to 100% export oriented units. The duties on capital goods have now been lowered to a range from 20% to 40%. Even with these reductions, India's customs duty rates are still too high and the Government has indicated that it will continue the process of lowering tariffs over the next two years to reach levels comparable with other developing countries.

Exchange rate policy has gone through a series of transitional regimes since 1991, leading to a total transformation at the end of three years. The reforms began with a devaluation of about 24% in July 1991 in a situation in which extensive trade restrictions were still in place. The devaluation was accompanied by an abolition of export subsidies to help the fiscal position, and an offsetting increase in export incentives in the form of special incentive licenses (Eximscripts) given to exporters which could be used to import items which were otherwise restricted. These licenses were freely tradeable and commanded a premium in the market depending upon the excess demand for restricted imports. The system was modified in March 1992 by the introduction of an explicit dual exchange rate system simultaneously with the dismantling of licensing restrictions on import of raw materials, other inputs into production and capital goods. These items were made freely importable against foreign exchange obtained from the market at a market determined floating exchange rate. Imports of certain critical items such as petroleum, essential drugs, fertiliser and defence related imports were paid for by foreign exchange made available at the fixed official rate, and the demand for foreign exchange at the official rate to pay for these imports was met by requiring exporters to surrender 40% of their export earnings at the official rate. The remaining 60% of export earnings was available to finance all other imports, all other current transactions and debt service payments, at the market rate. This dual exchange rate system was again a shortlived transitional arrangement to a unified floating rate which was announced in March 1993. After a year's experience with the unified rate the Government, in March 1994, announced further liberalisation of payment restrictions on current transactions and stated its intention of moving to current account convertibility. Capital controls however remain in place.

Thus in the short space of two and a half years the trade and payments system has moved from a fixed and typically overvalued, exchange rate operating in a framework of substantial trade restrictions and export subsidies, to a market determined exchange rate within a framework of considerable liberalisation on the trade account and the elimination of current restrictions. The transition is by no means complete, since consumer goods remain subject to quantitative restriction and tariffs are still high, but the changes made thus far are certainly substantial. The fact that they have been successfully managed has created the confidence necessary for an easy transition through the remaining stages.

The continuation of controls on the capital account is broadly in line with the current

consensus in the literature on sequencing which holds that liberalisation of the current account and an effective management of such a liberalised system should precede liberalisation of the capital account.

iv) Tax Reform

Reform of the tax system has been an important element in the Government's reform programme with major changes contemplated in both direct and indirect taxes. The broad directions of tax reform have been spelt out in the Report of the Taxation Reforms Committee (Chelliah Committee). The Committee has recommended a move towards a simpler system of direct taxation with moderate rates and fewer exemptions, a progressive reduction in the level as well as the range of variation of customs duties and a rationalisation of the domestic excise taxes on industrial production with a switch from specific to ad valorem rates, fewer duty rates and a drastic reduction if not elimination of exemptions. Substantial progress has been made in these directions in the four Budgets that have been presented since the reforms began and this is best seen by considering the cumulative changes that have taken place in each of the major areas of taxation:

- The maximum marginal rate of personal income tax was 56% in June 1991. This has now been reduced to 40%.
- The incentive structure for savings in the form of financial assets has been strengthened. The Wealth Tax, which was earlier applicable to all personal assets, has been modified to exempt all productive assets including financial assets such as bank deposits, shares and other securities.
- The rates of corporate income tax, which were 51.75% for a publicly listed company and 57.5% for a closely held company have been unified and reduced to 46%. All these rates are inclusive of a 15% surcharge. Without the 15% surcharge the rate of corporate tax would be 40% which is the same as the maximum marginal rate on personal taxation.
- Customs duties, as noted above, have been significantly reduced over the past three years and the Government has indicated that further reductions are expected to be implemented in phases to bring the rates in line with those prevailing in other developing countries.
- Excise duties on domestic manufactured goods were charged at varying rates on different commodities, with most of the duties being specific rather than ad valorem. There were also a large number of exemptions. A system of tax credit for taxes paid on inputs called Modified Value Added Tax or MODVAT was in force but excluded important sectors such as textiles and petroleum. Duty credit was also not available on excise duty paid on capital goods at the time of investment. The Budget presented in February 1994 has greatly simplified the system, with the bulk of the taxes shifted to an ad valorem basis and the number of exemptions greatly reduced. The coverage of the tax credit for taxes paid on inputs has been extended to include petroleum and capital goods. The number of excise duty rates has been reduced from 21 to 10. A start has also been made in extending indirect taxation to a few services by imposing a 5% tax on telephone bills, premium payments for general insurance and stock brokers' commissions. The longer term objective of the Government is to move to a Value Added Tax, but this is still a distant prospect since it involves integration of the taxes on production, which under the Constitution are levied by the Central Government, with taxes on sales which are levied by State Governments.

These reforms in the tax system go a long way towards the objective of creating a system which avoids economic distortions, and ensures adequate buoyancy of revenues to support the task of fiscal consolidation. The changes in tax structure will have to be accompanied by major improvements in tax administration to realise the full potential of reforms in this sector. The Government has indicated that this is high on its agenda.

v) Public Sector Policy

Reform of the public sector is a critical element in structural adjustment programmes all over the world and is also included on India's reform agenda. However, this is an area where changes are being implemented slowly. Unlike the case in many other countries, where public sector reform has involved explicit programmes of outright privatisation of public sector units combined with closures of unviable units, the approach adopted in the Indian reform programme is more limited.

Instead of outright privatisation the Government has initiated a limited process of disinvestment of Government equity in public sector companies, with Government retaining 51% of the equity and also management control. The disinvestment helps provide non-inflationary resources for the Government Budget, without adding to the fiscal deficit. However this is not the only objective. The emergence of private shareholders in public sector units and trading of public sector shares in the stock markets are both expected to make public sector managements more sensitive to commercial profitability. This is especially so since the Government has decided not to use budgetary resources to finance public sector investment in industry. Public sector companies have been given a clear signal that in future their investment plans must be financed either by internal resource generation or by resources raised from the capital markets - both alternatives being bound to encourage and reward efficiency and commercial orientation. A number of public sector units have resorted to the capital markets to raise resources to finance their investment plans and this trend is certain to accelerate in future.

The policy towards loss making public sector units is also cautious. The Government has announced that budgetary support to finance losses will be phased out over three years and this has had a salutary effect in confronting public sector units with a hard budget constraint. This needs to be supplemented with a policy for active restructuring of these units wherever it is possible to make them economically viable, and with closure combined with adequate compensation for labour where it is not. The Government has not ordered any closures on its own initiative, but an objective process for determining whether a unit should be closed or not has been initiated by amending the Sick Industrial Companies Act (SICA) to bring sick public sector companies under the purview of the Board for Industrial and Financial Reconstruction (BIFR) in the same way as private sector companies are covered. Sick public sector companies (defined under the law as companies which have completely eroded their net worth) are now automatically referred to the BIFR which will then consider whether a consensus can be evolved among the existing management (i.e. Government, creditors and labour) for a viable restructuring package which may involve some voluntary burden sharing by all parties - banks may offer to reschedule loans, workers to accept partial retrenchment or wage freezes, Government may have to give up taxes due etc. The Board can also consider revival packages involving induction of new managers, with a fresh injection of capital. If no consensus can be evolved for a revival package the BIFR is authorised to order closure of the unit and liquidation of its assets. This is a lengthy process but it does provide an objective means of exploring ways of reviving sick public sector units, with closure as a credible ultimate threat in extreme cases.

vi) Financial Sector Reform

The reforms in the real sector aim at creating a new set of incentives which will encourage reallocation of resources towards more efficient uses. This process needs to be underpinned by a parallel process of financial sector reform which will enable the financial sector to mobilise savings and allocate them in a manner which supports the process of restructuring in the real economy. Several initiatives have been taken in these areas covering both the banking system and the capital markets.

As far as banking system reform is concerned, the Government has announced a package of reforms to be implemented over a three year period based on the report of the Committee on the Financial System (Narasimham Committee). The high reserve requirements applicable to banks in the form of the statutory liquidity ratio (SLR) and the cash reserve ratio (CRR) were essentially designed to support Government borrowing at below market rates of interest and constituted a hidden tax on financial intermediation. The Government

has announced that these high reserve requirements will be progressively reduced, and the process has already begun. Parallel with the reduction in the requirements for compulsory investments by banks in Government securities, the interest rates on Government securities are increasingly market determined. Interest rate regulation in the banking system is also being reduced and rationalised. Earlier the Reserve Bank of India prescribed a number of different interest rates on deposits of different maturities and also a large number of prescribed lending rates for different sectors and classes of borrowers. Deposit rates for different maturities have now been freed subject only to a single ceiling. The proportion of deposits which banks can accept in the form of Certificates of Deposits, which are completely free from interest rate regulation, has been increased. On the lending side the number of prescribed interest rates for different types of borrowers has been reduced from six to three and it is proposed to move to an even simpler system with only one concessional rate and a single floor rate for all other loans.

Prudential norms relating to income recognition, provisioning and capital adequacy applicable to banks, have been brought in line with Basle Committee standards and these norms are being phased in gradually to be fully in force by March 1996. Combined with improved accounting practices and management information systems in the banks, this is expected to yield a much better picture of the true financial condition of the banks. This in turn will improve the quality of lending and generate pressures for greater efficiency among borrowing units. The absence of such pressures from the banking system in the past has been one of the reasons for pervasive inefficiency in many sectors of the economy.

The new norms reveal that the nationalised banks, which account for about 90% of total deposits, have a much higher proportion of non-performing assets than was earlier supposed. Full provisioning for these assets will inevitably lead to substantial impairment of capital and this means the nationalised banks will require extensive injection of fresh capital to meet the new capital adequacy norms. The Government has announced a programme of contributing fresh capital to the nationalised banks which involves a substantial burden on the Budget. This is unavoidable, reflecting the real cost of past banking inadequacies. However, in order to mitigate the impact on the Budget it is envisaged that the relatively stronger nationalised banks with good balance sheets will mobilise additional capital from the market by issuing new equity to the public. This will dilute the present 100% Government ownership of these banks by bringing in new private shareholders though Government equity will remain at least 51%. It is expected that the induction of private shareholders will create an environment in which these banks will pay much greater attention to the commercial viability of their operations.

The banking system is also being opened up to competition from new private banks and several new banking licenses have been granted. Branches of foreign banks have also been expanded to increase competition. All these policy changes will be supported by improved supervision by the Reserve Bank of India and strengthening of the management systems within the nationalised banks. The Government has also set up special Debt Recovery Tribunal to help facilitate recovery by banks from defaulting borrowers. The end result of these initiatives should be a much more efficient banking system which would support greater efficiency in the real sector.

Parallel with efforts to reform the banking system the Government has also embarked on a major reform of the capital market. During the eighties the capital market grew remarkably in size, with a sharp increase in the volume of resources being raised by the corporate sector in the form of corporate debt and new equity. The size of the investing public also expanded considerably especially in the form of subscribers to mutual funds. This quantitative expansion was not however matched by necessary qualitative improvements. India's stock exchanges have shown considerable dynamism, but they remained inadequately regulated and suffered from lack of transparency in trading practices. Supervision was not up to the level required to ensure investor protection.

Several important initiatives have been taken in the past two years to remedy these deficiencies and raise standards to those prevailing in countries with well functioning efficient capital markets. The requirement of Government permission for companies issuing capital, as well as the system of Government control over the pricing of new issues of equity by

private companies, has been abolished with the repeal of the Capital Issues Control Act in May 1992. Firms are now free to issue capital and price new issues according to market conditions subject only to guidelines aimed at effective disclosure of information necessary for investor protection. The Securities and Exchange Board of India (SEBI) has been established as an independent statutory authority for regulating the stock exchanges and supervising the major players in the capital markets (brokers, underwriters, merchant bankers, mutual funds, etc). The focus is not on control and Government intervention but on establishing a framework of regulation to ensure transparency of trading practices, speedy settlement procedures, enforcement of prudential norms and full disclosure for investor protection.

An important initiative taken as part of the reforms is the opening up of the capital market for portfolio investments. Indian companies have been allowed to access international capital markets by issuing equity abroad through the mechanism of Global Depository Receipts. Foreign institutional investors managing pension funds or other broad based institutional funds have been allowed to invest directly in the Indian capital markets. Favourable tax treatment has been granted to such investments to encourage capital inflows through these routes. These initiatives have come at a time when international fund managers are diversifying their portfolios by investing in "emerging capital markets" and India has benefited from this trend along with other developing countries. It is estimated that inflows from international equity issues by Indian companies in 1993-94 amounts to about \$2.5 billion, while foreign institutional investors have invested about \$1.5 billion in the domestic capital markets.

vii) Reforms and the Agricultural Sector

With over 70 per cent of the population in rural areas, and most of them dependent on agriculture, it follows that the strategy for economic reforms must address the constraints on efficiency and production in the agricultural sector. Much of what needs to be done in this area consists of effective implementation of the basic strategy for agricultural development that has worked well in many parts of the country and needs to be extended to other parts. This calls for substantial investments in land and water management, supply of improved seeds, an effective system for delivery of rural credit and of course security of tenure. Many of these elements fall within the area of responsibility of State Governments.

A disturbing feature of recent trends in the agricultural sector *is* that real investment in agriculture, both public and private, has been stagnant. There is need for substantial increase in public investment in agriculture and irrigation but this can only happen if resources available for investment with the State Governments can be increased. Unfortunately, investible resources with State Governments have been seriously eroded because of large increases in unproductive current expenditure and the heavy burden of losses on the provision of basic economic services in rural areas such as electric power and irrigation. Top priority must be given to reducing these implicit subsidies through rational pricing of both water and electricity and also better management. The resources thus saved should be devoted to increased investment in agriculture and related rural infrastructure.

One dimension in which agriculture will be helped by the new policies is the expected general equilibrium impact of reduced protection to industry, which should reduce the anti-agriculture bias of the earlier high protection regime. The new regime not only makes agricultural exports more competitive at the new exchange rate, it also stimulates the growth of the agro-processing industry, with strong backward linkage to agriculture. A logical extension of the current programme of reforms is the elimination of all restrictions on movement of agricultural commodities both domestically (across States) and also for exports. This has been accepted as an element of the economic reforms. All Central Government restrictions on domestic trade have been removed though some State Governments restrictions remain. Restrictions on agricultural exports have also been reduced significantly though not as yet fully eliminated. Some of the remaining restrictions, such as for example the restriction on exports of pulses and coarse grains are not really binding in practice but have been continued with an eye to avoiding any psychological pressure on prices.

A major area where policy reforms can help agriculture is in the area of rural credit. Poor banking practices, including especially laxness regarding loan recovery, has greatly weakened the cooperative credit system and has also weakened rural lending by the commercial banking system. The financial sector reforms currently underway will address this problem through a combination of rationalisation of interest rates to reduce the disincentive of unviable lending rates which discourage rural lending, recapitalisation of banks and restructuring of cooperative credit institutions.

viii) Labour Market Reforms

A commonly heard complaint from domestic as well as foreign investors is that labour markets are unduly rigid. Indian labour laws provide a high degree of protection to labour with retrenchment of labour and closure of an unviable unit requiring prior permission of the State Government for units employing more than 100 workers. Such permission is not always granted and this leads to the complaint that Indian firms lack the flexibility they need to adapt to changed economic circumstances. Spokesmen of domestic industry, and also foreign investors, make the point that firms must have the ability to retrench labour and to close down unviable units if necessary or else they will not be able to compete effectively with the rest of the world in a more open economy. This flexibility is also relevant if old firms, with a hangover of excess labour, have to compete with new firms without this burden.

One of the lessons from the literature on sequencing is that if some markets take longer to adjust than others, it is important to begin with reforms in the markets which adjust slowest. On this basis, reforms in the labour markets should have top priority since labour market typically take longer to adjust. However it is also important to recognise that reform of labour laws is a politically sensitive issue. Any weakening of the labour laws is likely to evoke fears of widespread unemployment and this is especially the case at the early stages of the reforms when the beneficial effect of the new policies in terms of more rapid growth of output and employment has yet to gain momentum. There is recognition, even in official circles, that excessive rigidity in the Labour Laws may not be in the interest of employment creation, but a consensus on how to tackle this problem has yet to emerge.

In any case, reform of labour laws must come after the creation of credible safety nets to deal with the problems of displaced labour. A first step in this direction has been taken by the creation of a National Renewal Fund which will finance compensation payments to labour rendered redundant in the course of public sector restructuring and closure of unviable units. It will also finance retraining programmes to help redeploy such labour. Financing for the fund is being provided from the Central Budget and resources have been obtained from multilateral and bilateral aid donors in support of this activity. Approximately 20,000 workers were laid off and paid compensation from the NRF in 1992-93 and a similar number again in 1993-94. As the process of restructuring public sector firms gains momentum the NRF will play a larger role in years to come.

III. A Tentative Assessment

The reforms described in the previous section clearly go beyond piecemeal adjustments of one or other aspect of policy. The reforms are far reaching and cover several sectors of the economy in a mutually re-inforcing fashion. It is however too early to attempt a definitive assessment of their impact on the economy. In some areas, such as for example in the financial sector, the reforms are still in the initial stages of implementation. Even where progress has been rapid, as for example in industrial deregulation and trade liberalisation, there are unavoidable lags before the economy can respond, especially where the total response depends upon investment and the resulting creation of new capacity. Nevertheless, it is useful to assess the results achieved in terms of economic performance in the first three years.

The success in managing the short term crisis and stabilising the economy are impressive. Inflation has been reduced from a peak of 17% in August 1991 to about 8.5% within two and a half years. Foreign exchange reserves have increased from \$1.2 billion in June 1991 to over \$15 billion in March 1994. Exports have responded well to the new trade policy and the exchange rate regime, and exports (measured in US dollars) have grown by about 21% in the first ten months of 1993-94. International confidence has been restored and there is an

upsurge of investor interest in India both for direct foreign investments and also for portfolio investment.

The results in terms of the medium term objectives of stimulating growth and investment are less dramatic at this stage, but this is not altogether surprising. Many countries going through structural adjustment have experienced sluggish, and indeed even negative, growth in the early years. India's experience of structural adjustment has been much less painful. GDP growth dropped to 1.1% in 1991-92, which was the first year of the reform, but it recovered to about 4% in 1992-93 and is expected to continue at about the same rate in 1993-94. Growth has not collapsed, but it is also true that the economy has not yet recovered to its previous trend performance of 5.5% growth in the 1980s. Even the growth achieved in 1992-93 and 1993-94 is largely on account of a good performance in agriculture and the tertiary sector.

Industrial growth, which is the main target of industrial and trade reforms, remained sluggish at 1.8% in 1992-93 and is unlikely to exceed 3.5% in 1993-94. A slowdown in industrial growth in the initial phase of economic reform was not unexpected as Indian industry adjusted to the new competitive environment. However, the success of the reforms will inevitably be measured by how quickly the system returns to the earlier levels of 7 to 8% growth in industry. In fact the medium term objective should be to accelerate quickly beyond this level. If the aim of the reforms is to enable the economy to achieve growth rates of GDP of 6 to 7% in a sustainable manner this can only be achieved if the industrial sector grows by about 10%.

The transition to a higher and growth path for the economy, and one which is sustainable from the balance of payments point of view, requires a revival in total investment. The first two years of the reforms saw a slight decline in the rate of investment (Gross Fixed Capital Formation as a per cent of GDP) from 22.8% in 1990-91 to 21.3% in 1992-93. National accounts data for 1993-94 are not yet available, but the rate of investment is unlikely to have increased. Public investment has been low because of severe resource constraints affecting State Governments. Private investment has also been depressed as the corporate sector re-orientes its investment strategy to the new economic environment with greater domestic competition and lower protection. Such reductions in the rate of investment have occurred in other countries going through structural adjustment. To some extent the lower rate of investment may be offset by greater efficiency in capital use, and indeed this is a critical objective of much of the structural reforms. However a revival of economic growth to levels above the 5.5% achieved in the 1980s will definitely call for higher rates of investment in the years ahead.

There is evidence that private investment activity is beginning to revive and the new investment will be more efficient. Corporate strategies are being re-oriented to enable companies to perform effectively in the emerging, more competitive environment. Firms are paying much more attention to modernisation of existing plants than to creation of new capacity in greenfield sites, and this is a desirable development since such investments are more cost effective. Several companies are also undertaking labour rationalisation through voluntary retirement schemes to ready themselves for stiffer competition. Financial sector reforms, including especially the efforts being made to strengthen capital markets, are creating an environment in which firms with a good track record and market appeal are able to raise substantial volumes of capital both domestically and internationally to finance modernisation and expansion. Increased interest by foreign investors looking for joint venture partners is also helping to stimulate investment optimism on the part of domestic firms through tie ups with global partners.

The revival of private investment will also need to be supported by higher level of public investment in critical infrastructure areas such as power, railways, roads, ports and irrigation. The new policies allow, and indeed encourage, private investment in critical areas such as power and petroleum exploration, and a limited beginning is also being made to induct private investment in roads and ports. Telecommunication is another area where new initiation are under consideration. However the quantitative significance of private investment in these areas is bound to be modest initially and can only supplement the public sector effort. The ability of the public sector to undertake the large investments needed in

the medium term is therefore critical for the success of the reforms. This will in turn depend upon improved financial performance of major public sector organisations such as the State Electricity Boards and also an improvement in the fiscal position of both the Central and State Governments.

Improvement in the fiscal position of the Central and State Government is important not only to bring about a revival of investment in infrastructural but more generally for creating a favourable macro-economic environment in which the reforms can operate. Successful management of a liberalised and more open economy, with increasing liberalisation of the financial sector, depends crucially upon the fiscal deficit being reduced substantially from present levels. This is a key element of the current strategy and as long as progress in this dimension continues, there is good reason to expect that the reforms launched in 1991 will succeed in shifting the Indian economy on to a higher growth path.