NYU STERN

The Global Economy
Mini-Case

Reform and Growth in India

Revised: April 11, 2006

India's growth rate has increase dramatically since 1980. But why? The standard story is that deregulation and more open trade are the cause, but there is a mismatch in timing: the growth rate increased starting in about 1980, yet most of the dramatic changes in policy took place in the 1990s.

Questions:

- Describe the growth rates by decade.
- Describe policy
- What do you think happened?
- What policies would you recommend India follow in the future?

Evidence:

- Spreadsheet with data: GDP, growth components,
- ..

Exhibit 1. India's Trade Liberalization.

From: Prachi Mishra and Utsav Kumar, "Trade liberalization and wage inequality: evidence from India, International Monetary Fund, January 2005. [link]

Following independence from the British rule in 1947, India embarked on a socialist strategy of development, which envisaged a heavy role for the government and the public sector in shaping Indias economy and industrialization. The strategy relied on import-substitution [producing imported goods locally], emphasized the role of the government in providing infrastructure, as a regulator, and as a provider of goods and services.

Throughout the 1960s and 1970s, the growth rate of GDP in India had been stagnant at 3-3.5 percent per annum (what came to be known as the *Hindu* rate of growth). Beginning in the early 1980s, there was some emergence of thinking about the need for a change in trade policy (Das, 2003). During the 1980s, the limitations of inward oriented development strategy, import substitution based industrialization, extensive government control, and the license raj were becoming increasingly evident.

The trade regime in the early 1980s was characterized by high nominal tariffs and nontariff barriers coupled with a complex import licensing system. In addition, Indias tariff structure was very complex with a myriad of exemptions applicable to the basic duty rate and this was one of the areas which the trade reforms initiated in 1991 dealt with.

During the late 1980s, the then government took the first steps towards reducing state control. These were not only on the external policy front but also related to domestic industrial policy. Steps were taken to ease industrial and import licensing, replace quantitative restrictions with tariff barriers, simplify the tariff structure, and importantly, this was the first instance of a three-year trade policy. There were conscious efforts to dismantle the import licensing regime via reductions in the number of products listed under banned/restricted category. However, these measures were too little and left a lot to be desired. [Until] 1991, the levels of protection were very high — in 1991, the average tariff rate was 117 percent and the import coverage ratio was 82 percent.

The years 198991 were marked by difficulties, both on the economic and political fronts. As the new government took over the treasury benches in 1991, India was facing an impending external payments crisis with foreign currency assets less than US$1 billion, just enough to cover two weeks of imports.

The Government of India requested a Stand-By-Arrangement from the IMF in August 1991 and entered into an IMF-supported program. In addition to deficit reducing policies, a wide array of policies spanning the external, trade, industrial, public sector, financial and banking sectors were implemented. Some of the measures on the external front included elimination of the monopoly of state trading agencies, easing of import licensing, removing export restrictions, allowing foreign investment into the previously reserved sectors and full convertibility of domestic currency on foreign exchange transactions.

The export-import policy (EXIM policy) of 1992-97 reaffirmed Indias commitment to freer trade. All import licensing lists were eliminated and a “negative” list was established. Except consumer goods, almost all capital and intermediate goods could be freely imported subject to tariffs. By April 2002, all the remaining quantitative restrictions were removed. Despite all the initial opposition to liberalization, reforms have been continued by every successive government.

?? Add data and figures....

Exhibit 2. The 1991 Reforms.

From: Petia Topalova, “Trade liberalization and firm productivity: the case of India, International Monetary Fund, February 2004. [link]

Indias post-independence development strategy was one of national self-sufficiency, and stressed the importance of government regulation of the economy, characterized as “both inward looking and highly interventionist, consisting of import protection, complex industrial licensing requirements, pervasive government intervention in financial intermediation and substantial public ownership of heavy industry.” In particular, Indias trade regime was amongst the most restrictive in Asia, characterized by high nominal tariffs and pervasive non-tariff barriers, including a complex import licensing system, an “actual user policy that restricted imports by intermediaries, restrictions of certain exports and imports to the public sector (“canalization), phased manufacturing programs that mandated progressive import substitution, and government purchase preferences for domestic producers.

It was only during the second half of the 1980s, when the focus of Indias development strategy gradually shifted toward export-led growth that the process of liberalization began. Import and industrial licensing were eased, and tariffs replaced some quantitative restrictions, although even as late as 1990 a mere 12 percent of manufactured products could be imported under an open general license; still, the average tariff was more than 90 percent.

However, concurrent with the gradual liberalization in the mid to late 1980s was a rise in macroeconomic imbalances — namely fiscal and balance of payments deficits. The sudden increase in oil prices, resulting from the conflict in the Middle East in 1990, the drop in remittances from Indian workers in the same region, and the slackened demand of important trading partners, as well as political uncertainty, undermined investor confidence and resulted in large capital outflows. To deal with its external payments problems, the government of India requested a Stand-By Arrangement from the IMF in August 1991. The IMF support was conditional on an adjustment program featuring macroeconomic stabilization and structural reforms. The latter focused on the industrial and import licenses, the financial sector, the tax system, and trade policy. On trade policy, benchmarks for the first review of the Stand-By Arrangement included a reduction in the level and dispersion of tariffs, a removal of quantitative restrictions on imported inputs and capital goods for export production, and elimination of public sector monopoly on imports of all items except petroleum, edible oils, and fertilizer and certain items canalized for health and security reasons.

The governments export-import policy plan (1992-97) ushered in radical changes to the trade regime by sharply reducing the role of the import and export control system. The share of products subject to quantitative restrictions decreased from 87 percent in 1987/88 to 45 percent in 1994/95. All 26 import licensing lists were eliminated and a “negative list was established. Restrictions on exports were also relaxed, with the number of restricted items falling from 439 in March 1990 to 210 in March 1994.

In addition to easing import and export restrictions, tariffs were drastically reduced. Average tariffs fell from more than 80 percent in 1990 to 37 percent in 1996. ... The Indian rupee was also devalued by 20 percent against the US dollar in July 1991, and further devalued in February 1992. Subsequently, it became fully convertible for current account transactions. The economy reacted positively to the reduction in trade distortions and, as a result, the ratio of total trade to GDP rose from an average of 13 percent in the 1980s to nearly 19 percent of GDP in 1999/00. Export and import volumes also increased sharply from the early 1990s, outpacing growth in real output.

India remained committed to further trade liberalization, and since 1997, there have been further adjustments to import tariffs. However, at the time, the government announced the export-import policy in the Ninth Plan (19972002), sweeping reforms outlined in the previous plan had been undertaken and pressure for further reforms from external sources had abated.

Exhibit 3. The Mystery of the 1980s.

From: Dani Rodrik and Arvind Subramanian, "From 'Hindu Growth' to Productivity Surge: The Mystery of the Indian Growth Transition," International Monetary Fund, May 2004. [link]

Indias economic performance during the first three decades since independence in 1947 was christened the "Hindu rate of growth, a term connoting a disappointing but not disastrous outcome and the acquiescence in the present that the religion supposedly imbues, because of its greater emphasis on the hereafter.

This term is, of course, gradually lapsing into disuse thanks to the remarkable transformation in India during the last two decades. Since 1980, its per capita economic growth rate has more than doubled, rising from 1.7 percent in 195080 to 3.8 percent in 19802000. Shackled by the socialist policies and the "license-permitquota raj of the past, India used to serve as the exemplar of development strategies gone wrong. It has now become the latest poster child for efforts to unleashed economic growth with a turn toward free markets and open trade. India has yet to catch up to Chinas growth rates (or even to Chinas level of income), but thanks to its solid democratic institutions and impressive performance in information technology, the country is in the eyes of many knowledgeable observers increasingly vying with, if not displacing, China to be the country of the future.

The improvement in Indias economic performance is obviously good news for its one billion people. But equally important, this transformation also holds out hope for other poor countries around the world, insofar as it sends the message that rapid economic growth is attainable under appropriate policies.

But what exactly are those "appropriate policies that made the Indian miracle possible? The conventional story about India, which can be glimpsed in any number of policy-oriented papers and newspaper articles, goes like this. Until 1991, Indias policy-makers followed misguided policies that closed the economy to international trade, erected inefficient industries under state guidance, riddled the private sector with extraordinarily cumbersome and detailed regulations, and suffocated private economic activity with controls and bureaucratic impediments. Then, in 1991, the big breakthrough happened. Spurred by a balance of payments crisis, Indian policy-makers turned to technocrats such as Manmohan Singh, who promptly began the process of liberalizing the economy. Trade barriers were slashed; foreign investment was welcomed; the license raj was dismantled; and privatization began. The economy started to boom, with software exports and call centers leading the way.

Like all caricatures, the above story has elements of truth in it. It is indeed the case that, until recently, India had one of the most overregulated and closed economies in the world. It is also true that the economic liberalization of 1991 constitute a watershed event for the Indian economy. But the main difficulty with the standard account, as summarized here, is that the pickup in Indias economic growth precedes the 1991 liberalization by a full decade. Even a cursory glance at the growth record reveals that the more-than-doubling of Indias growth rate takes place sometime around 1980, with very little discernible change in trend after 1991. In fact, some indicators, such as economy-wide total factor productivity, even go in the "wrong direction, showing a deceleration after 1991. Therefore, the striking post-1980 improvement in performance cannot be attributed to the liberalization of 1991. The latter may well have played a role in sustaining and deepening an ongoing process of growth, but we need to look elsewhere to understand how India made the transition to high growth. A related implication is that more recent phenomena, such as the boom in information technology and related services, cannot have been the original source of Indias economic growth.

We present in this paper a somewhat different interpretation of Indias experience. We argue that the trigger for Indias economic growth was an attitudinal shift on the part of the national government in 1980 in favor of private business. Until that time, the rhetoric of the reigning Congress Party had been all about socialism and pro-poor policies. When Indira Gandhi returned to power in 1980, she realigned herself politically with the organized private sector and dropped her previous rhetoric. The national governments attitude toward business went from being outright hostile to supportive. Indira Gandhi switch was further reinforced, in a more explicit manner, by Rajiv Gandhi following his rise to power in 1984. This, in our view, was the key change that unleashed the animal spirits of the Indian private sector in the early 1980s.

It is important to characterize appropriately the attitudinal change that took place in the early 1980s. We draw a distinction here between a promarket and a probusiness orientation. The former focuses on removing impediments to markets and aims to achieve this through economic liberalization. It favors new entrants and consumers. A probusiness orientation, in contrast, focuses on raising the profitability of the established industrial and commercial establishments. It tends to favor incumbents and producers. Easing restrictions on capacity expansion for incumbents, removing price controls, and reducing corporate taxes (all of which took place during the 1980s) are examples of probusiness policies, while trade liberalization (which did not take place in any significant form until the 1990s) is the archetypal market-oriented policy. This distinction can be observed, for example, in the contrasting approaches toward reform in East Asia and Latin America. Koreas reforms in the 1960s and 1970s were primarily probusiness rather than promarket. Latin Americas reforms in the 1990s were primarily promarket.

The change in India in the early 1980s are accordingly best described as probusiness rather than promarket. True liberalization was, by and large, anathema to organized business at the time. Indira Gandhi was far less interested in opening up the economy and removing impediments to competition than in garnering political support from existing business groups. Rajiv Gandhi, who was somewhat more prone to liberalize, had to step back when he stepped too far out of line and when the Bofors scandal undermined his effectiveness. The primary beneficiaries of growth were therefore incumbents and preexisting activities rather than new entrants and activities. Nevertheless, we view this shift toward a probusiness orientation as the essential trigger that set off the boom of the 1980s. That this was a powerful trigger can be deduced from the fact that the genuine liberalization after 1991 added very little to aggregate economic performance. Apparently, this attitudinal shift was, in itself, a very powerful stimulant for economic growth, even in the presence of price and other market distortions.

That an attitudinal change on the part of the national leadership could have such a strong impact on growth is, in turn, grounded in Indias initial conditions. India has very strong political and economic institutions for a country at its income level. It is a democracy where the rule of law generally prevails and property rights are protected adequately. Judged by cross-country norms, it ought to have a level of income that is several times higher. The implication is that relatively minor changes in the policy environment can produce a large growth impact. We interpret the suspension of the national governments hostility to the private sector as one of these changes, something that left little paper trail in actual policies but had an important impact on investors psychology.

Exhibit 4. Data?? .

From: Deb Kusum Das, "Quantifying trade barriers: has protection declined substantially in Indian manufacturing?" Indian Council for Research in International Economic Relations, July 2003. [link]

???