

**India's Economic Growth and Global Integration:  
Experience since Reforms and Future Challenges**

T.N. Srinivasan\*

It is well known that India's development strategy since 1950 until the systemic reforms of after 1991 and some hesitant piecemeal reform in the mid eighties was articulated through five year and annual plans put together by the Planning Commission. Although a large share of GDP and even larger share of employment were generated by the private sector, the state played a dominant role in three ways: first, by emphasizing import substitution across the board and industrialization as core strategies, second, by appropriating a large share of the savings of the economy for its own use, largely for public investment until the eighties and also for public consumption thereafter; and third, by attempting to steer the private sector to conform to the priorities and targets set in the plans through various instruments of controls, many of which were in the form of quantitative restrictions rather than of taxes and subsidies. Moreover, most of the instruments of control were exercised on a discretionary, case-by-case basis, rather than through a set of rules and in effect insulated producers from domestic and international competition.

At its most expansive and inclusive, the system involved the following: *industrial licensing* under which the scale, technology, and location of any investment project other than relatively small ones were regulated and permission from the government was needed to expand, relocate, and change the output or input mixes of operating plants; the *exchange control system* which required exporters to surrender their foreign exchange earnings to the Reserve bank of India at the official exchange rate, and allocated the exchange earnings to users through *import licensing*; *capital issues control* under which access to domestic equity markets and debt finance was controlled; *price controls* (complete or partial) on some vital consumption goods (for example, foodgrains, sugar, vegetable oils) and

---

\* Samuel C. Park Jr Professor of Economics and Non-resident Senior Fellow, Stanford Center for International Development, Stanford University.

critical inputs (for example, fertilizer, irrigation water, fuel); *made-to-measure* protection from import competition, granted to domestic producers in many 'priority' industries, including in particular the equipment producers. The agricultural sector was insulated from world markets, subjected to land ceiling and tenancy legislation, and forced to sell part of the output at fixed prices, but it was also provided subsidies on irrigation, fertilizer, and electricity. Large commercial banks, which were nationalized in 1969, were subject to directed and selective credit controls, controls on deposit and lending rates, and in effect had to lend more than half of their loanable funds to government through the operation of reserve requirements of various kinds.

The controls taken together were far more restrictive than each of them individually. For example, grant of an industrial license did not imply grant of a capital goods import license so that the capacity licensed could not be operational if the intended imports were essential. Besides the crucial aspect of all the regulations is the uncertainty about their fair implementation because they were essentially *discretionary* rather than *rule-based* and *automatic*. Although some principles and priorities were to govern the exercise of these regulatory powers, these were largely non-operational for two reasons. First it was impossible, even in theory, to devise a set of principles or rules for all the myriad categories of regulation that were mutually consistent and in consonance with the multiple goals of the industrial policy framework, which in themselves were not entirely consistent. Second, the problem of translating whatever rules there were into operational decisions was one of Orwellian dimensions. The allocative mechanism was largely in the form of quantitative restrictions unrelated to market realities. A chaotic incentive structure and the unleashing of rapacious rent-seeking and political corruption were the inevitable outcomes. Indeed, the discretionary regulatory system instituted in the name of planning for national development instead became a cancer in the body politic.

Another dimension of the exercise of regulatory power was that it was *anticipatory* in nature—that is, the regulations were meant to *prevent* the occurrence of any prospective deviation from the objectives of policy by firms or other regulated entities rather than to *punish* or cure any deviant behavior that actually occurred. While preventive, rather than curative, medicine is often preferable in health care systems, clearly it is not appropriate in industrial regulations. But in India a system of *curative* health care and *preventative* industrial regulations has been in existence since the 1950s!

Three decades of planning, state controls and insulation delivered an average growth rate of real GDP 3.75% per year during 1950-80. I do not wish to delve deeply

into the political economy of India's development strategy prior to reforms except to say that at the time of independence there was a consensus across the political spectrum on planning for development, the dominant role for the state and for insulation from world markets as well. When a massive balance of payments crisis emerged in 1966 as the second five year plan with large investment in heavy industry was about to end, a severe drought in 1965 resulted in the need for large imports of food. India approached the World Bank and IMF for assistance. Their conditionalities for assistance included devaluation and economic liberalization. The rupee was devalued and liberalization of import and other controls was announced. Largely because of opposition within her own party and the loss of seats in parliament in the 1967 general elections the then newly installed Prime Minister Mrs. Gandhi reversed liberalization measures in 1968 and in fact intensified them later on as part of her efforts to consolidate power. Until the early eighties, a few years before her assassination, she would not contemplate the dismantling of controls. Her son, Rajiv Gandhi, who succeeded her and won a huge majority in Parliament, though he wished to move the economy in a different direction, did not succeed in doing so again because of lack of support in his own party. Interestingly, East Asian countries which broke away from inward orientation and adopted outward orientation did so in the mid-sixties. Had Mrs. Gandhi not reversed India's opening and intensified it instead, in my view India would have replicated East Asian growth.

The intensification of controls as well as government interventions in agriculture in support of the green revolution through various subsidies and price supports created vested interests in their perpetuation as a system, while at the same time asking for and succeeding in getting those controls relaxed that turned out to be irksome. Although the

process of relaxation of controls here, and an increase of incentives of subsidies there, went on all the time, the mid-eighties saw more of them being undertaken. These, together with the abandonment of fiscal prudence of three decades, with fiscal deficits financed by borrowing at home and abroad, delivered an average growth rate of around 5.5% per year. With the rate of population growth having declined from around 2.2% per year during 1950-80 to 2% per year during 1980-90, rate of growth of per capita real GDP doubled in the eighties as compared to 1950-80. However, this growth was unsustainable as it was Latin style, debt-led, growth. It ended in a macroeconomic and BOP crisis in 1991 as the first gulf war broke and oil prices went through the roof. At the height of the crisis, foreign reserves were down to less than two weeks worth of imports, and short term external debt was several times the level of reserves.

It is no surprise that India went to the World Bank and IMF again as in 1966. The conditionalities for their assistance were also the same as before: devaluation and liberalization. What was different this time was the government initiated a set of systemic reforms that went beyond the conditionalities by eliminating investment and import licensing, unifying the exchange rate, undertaking a series of financial sector reforms, and actively seeking foreign direct investment rather than inhibiting as earlier. The economy responded well – the rate of growth GDP rebounded from 1.5% in the crisis year of 1991-92 to reach a peak of 7.8% in 1996-97. Subsequently, the growth rate fluctuated, through in the three years ending in 2005-06, it has averaged 8% a year.

In my view the reasons that systemic reforms were undertaken after the 1991 crisis rather than a return to status quo as happened after 1966, were basically two: the collapse of the Soviet Union and its planned economy on which Indian planning was

modeled and the rapid growth of China since its opening in 1998. Having fought and lost a boundary war with China in 1962, India could not afford to be left behind by China. It is also the case that many in India, in government, in politics, in business, in media and in the street, view China as India's only relevant economic rival and comparator. The outside world has also come to recognize the likely impact of rapid growth in the two giants will have on it. My background paper is addressed to the growth of the two giants and its global impact.

It is clear that compared to the debt-led growth of the eighties, the past 1991 growth is less likely to be unsustainable. However, India faces a number of challenges, if the recent growth of 8% per year is to be sustained and accelerated in the next couple of decades. An acceleration to 10% or faster is needed if India's poverty is to be eradicated once and for all. I will conclude with mentioning some of them.

First, in spite of more than 15 years of attempts to integrate India with the global economy, India's share in global merchandise exports rose from a measly 0.5% in 1993 only to 0.8% in 2004. During the same period China's share grew more than fivefold to 6.7% from 1.2%. As a share of GDP, exports and imports accounted for 31% for India's GDP in 2004 as contrasted to 65% for China. India has still a long way to go from being one of the most protected developing countries as it is now, to a truly open economy.

Second, the shares of China and India in global GDP and its growth has been increasing: India's share in global GDP 2004 (its growth during 2000-2004) at 1.67% (at 4.14%) was much lower than China's at 4.68% (17.60%), reflecting, of course, China's faster growth at around 9% per year compared to India's only 6% since 1980. India is still a very modest player in the global economic scene.

Third, turning to sources of growth, India's saving and investment rate were around 30% of GDP in 2004-05 compared to China's which exceeded 40%. Demographic trends are different in the two countries. China's working age population is projected to fall from over two-thirds of total population in 2005 to around half in 2050 and its dependency rate is projected to rise from around 60% to 90% during the same period. In India the share of working age is projected to remain at 60% and the dependency ratio to fall slightly from two-thirds during the same period. Moreover, India has a much larger share of working population in low productivity primary activities. Taken together, the demographic trends and life-cycle considerations would point first, to a rise in savings rates in India and a fall in China. With lower literacy and educational attainments than China, if India catches up, the contribution of human capital to growth would be higher than China's. While intersectoral shift of labour from low productivity activities will only attenuate the lower rate of growth of labour inputs, in India's case, the rate of growth of labour inputs will increase and will be augmented by intersectoral shifts. Turning to TFP growth, although in both countries the move away from insulation and dirigisme seems to have improved TFP growth, the available range of estimates do not suggest a distinct advantage for one country over the other, with both likely to experience a TFP growth of 2.5% to 3.1% per year in the future. In sum, India's growth rate is likely to accelerate and be sustained in the 8% - 10% range, while China's will remain at around 10% a year.

Fourth, China received \$74 billion in private capital flows in 2004 of which \$55 billion was FDI. The corresponding figures for India were \$19 billion and \$5 billion respectively. A number of factors relating to the poorer investment climate in India

explain this difference. India is only now creating Special Economic Zones (SEZs) like China started them in the early eighties and gave investors freedom to hire and fire as they pleased and provided excellent infrastructure. Full foreign ownership was allowed. Much FDI, particularly by overseas Chinese made China an export platform for labour-intensive manufacturers. India has not relaxed its draconian labour laws in SEZs and various sectoral caps apply to FDI. Infrastructure, particularly power is a continuing bottleneck in India. It is very unlikely that India would be able to replicate the success of Chinese SEZs.

Fifth, although there are some encouraging signs that India will be able to attract offshoring of manufacturers such as auto parts, India's manufacturing sector as a whole has not been a fast growing sector. Share of manufacturing in India's GDP is still less than 20%, far below China's. While China has been able to increase its share of the textiles and apparel market in Europe and North America as the MFA quotas were being phased out, India's share went up only modestly. In India the reservation of the production of apparel for small scale industries was removed only recently. There are still many exportable labour intensive manufacturers that are still reserved for the small scale sector. The restrictions of labour laws, archaic, time consuming and costly bankruptcy procedures have affected entry and exit. Unless reforms in all these areas are undertaken, it is unlikely that a substantial acceleration of growth of manufacturing will come about.

Sixth, the service sector exports, particularly by software and business process outsourcing and other IT enabled services, have grown very rapidly in India. However, even with its phenomenal growth, India cannot leap-frog the manufacturing stage of the

development process in shifting labour from agriculture and primary activities to more productive occupations.

Seventh, although India has a comparative advantage in agriculture and the export potential of high value crops including horticulture is huge, infrastructural bottlenecks and institutional rigidities relating to land use severely limit the possibilities of rapidly expanding agricultural exports.

Eighth, India's financial sector after reforms is better than China's. I will leave to Deputy Governor Mohan to comment on it. In conclusion, let me say that India has several institution and advantages over China: a thriving representative democracy, a well-developed private sector, a relatively entrenched legal system, and modestly better governance. Several bottlenecks I mentioned are not insurmountable: with a deepening, widening and acceleration of the reform process, they can be surmounted. This in turn means that India with China could fuel global economic growth.