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Economic reform aims to unleash India's potential

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India's Eighth Five Year Plan, larger in rupee outlay than any of the earlier plans, was officially launched on April 1, 1992, the beginning of the new fiscal year here. The plan, which had been hanging fire for the last two years as governments came and went one after the other, will be implemented in an economic climate which has changed significantly since the government of Prime Minister P.V. Narasimha Rao introduced a series of economic reforms beginning in July 1991.

The plan itself will be very different from previous plans. For the first time, more than 56% of plan investment will be made in the private sector. Making investment capital available to the private sector, allowing it to participate in activities which have been traditionally exclusively under the public sector's domain, reflects one of the broad aims of the economic reforms: to activate private industry to make its full contribution to dynamic economic growth. At the same time, the public sector's responsibility in social sectors has been increased and funding for the priority sectors assured. The detailed plan document will be available in early June following its approval by the National Development Council. From the outlines of the plan, it is evident that unlike earlier ones, the Eighth Plan's future is intricately connected to the success or failure of the present economic reforms and liberalizations.

In June 1991, when Prime Minister Rao, leading a minority Congress (I) Party, took over the Indian government, the political and economic environment had become untenable due to the political chaos and financial anarchy perpetuated by two successive short-lived governments, headed by V.P. Singh and Chandra Shekhar. India's domestic economy was in deep trouble and foreign exchange reserves, affected by large debt repayments and an increasing imbalance of payments, had hit a new low. Faced with the immediacy of a payments default, the Rao government moved swiftly: The Indian currency was devalued by about 30%, a new industrial policy was formulated emphasizing relicensing and deregulation of industries and reducing, albeit nominally, the fertilizer subsidy.

Within a year, these measures were followed by the decision to make the Indian rupee partially convertible, allow limited gold import for payment of customs duty, and a fairly substantial change in export-import policy. Financial, labor, and agricultural reforms are on the anvil.

The reform package, linked as it has been to India's taking of a $2.2 billion standby loan from the International Monetary Fund (IMF) to stave off default in July 1991, has provoked controversy at home and a fair amount of self-serving commentary abroad. Votaries of the "free market" dogma in the West announced India's conversion and abject submission to IMF conditionalities, "shock therapy," and the like. Here in India, the opposition charged the Rao government with handing over the country to the World Bank, IMF, and foreign multinationals. None of this has much to do with reality.

India's anti-free trade tradition

A close examination of the policy measures, against an in-depth knowledge of India's economic history, will show that any similarities with the "Brand X" monetarist medicine are essentially coincidental. India has a long tradition of sovereign economic science and policymaking that was decisively influenced by the national system of political economy

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The Red Fort in Old Delhi. India has a long tradition of sovereign economic science influenced positively by the ideas of Friedrich List and negatively by the free trade regime of British colonial rule. The Rao government reforms aim to return to that independent tradition.

of Friedrich List and India's own experience with British colonial rule. As one of India's early 20th-century economists, Vaman Govind Kale, said in his textbook *Indian Economics:* "The distinctive feature of the Indian school of thought is its intensely patriotic conception of the country's requirements in the sphere of material progress and the characteristically national interpretation of the facts of Indian life; and it was largely developed as a protest against the economic policy pursued by the rulers of the country with respect to its finance, trade and industries."

Later, Kale summarized the thinking of Indian economists on commercial policy: "It is therefore futile for outside critics to hope for the rise of a free trade school among the economic students of India. The latter appreciate the free trade doctrine in the abstract and will be influenced by it only to the extent that they will desire that protection to be adopted in this country should be of the right kind and the evils associated it with should, as far as possible, be avoided." Even though Kale wrote his textbook in 1922, it remains a true guide to the wellsprings of Indian economic policymaking and debate of today.

The Rao government's reform package is no draconian imposition by dark foreign forces. It is an attempt by Indian policymakers to address long-acknowledged problems that have kept the Indian economy in a kind of bare survival mode, squandering the country's obvious human and material potential to become a real economic powerhouse. How far the new measures will go to realize the potential is certainly debatable—not the least because policies in some of the most fundamental areas, such as agriculture, have yet to be spelled out in detail. Certain constraints and problems remain, as will be discussed below, and cheers from Indian businessmen have yet to be translated into new industrial capacity. But that the steps taken so far are uniquely addressed to setting right certain things in India's complex economic machine is clear—as the devaluation is perhaps the best example.

Devaluation: a case in point

Devaluation has a sinister reputation. Despite its established *inability* to enhance exports substantially or improve the balance of payments situation at all, it is usually undertaken with the promise of doing just that and ends up provoking an uncontrollable inflation or cutting off essential imports or both. In the Indian context, however, the devaluation has an altogether different meaning. First, India is not a trading nation: only 5.2% of its Gross Domestic Product (GDP) is traded annually, as opposed to over 25% in the case of, for example, the Southeast Asian nations. Hence, devaluation has only a nominal impact insofar as the balance of payments goes.

Second, despite India's established indigenous capability, Indian industries have remained significantly dependent on imports because of the costly rupee, among other things. (This dependency came to light during the chaotic days of

TABLE 1

The gold-smuggling racket and foreign exchange leakage, 1982-89

(value in rupees per 10 grams)

Year	Into India (metric tons)	Smuggled gold Value in Bombay	Value in London	Difference or profit
1982	60.0	1,033.80	750.00	283.80
1983	53.0	984.74	711.26	273.48
1984	94.0	1,874.38	1,222.83	652.05
1985	123.4	2,622.25	1,591.86	1,030.39
1986	88.4	2,053.53	1,394.07	659.46
1987	98.3	3,029.61	1,879.50	1,150.31
1988	134.1	4,251.68	2,628.36	1,623.32
1989	200.0	6,386.00	3,942.00	2,444.00

Source: Bombay Bullion Association.

These figures indicate that in 1989 alone $4.64 billion worth of foreign exchange was mopped up by the racket to buy gold. Besides the foreign exchange lost, these transactions also created a stupendous amount of black money inside the country. By keeping the value of the rupee high, the gold racketeers were having a feast.

the V.P. Singh regime when the government, watching payments balances dwindle and unable to bring in new foreign exchange, clamped down a severe restriction on imports. The result showed up sooner than expected. Industrial growth tumbled from an average of 8-9% from 1984 through 1989 to zero in 1991-92, and still the balance of payments kept sinking!) With foreign exchange dearer and domestic investment conditions improved, the industrialists are encouraged to "indigenize" a whole range of equipment and products for which technology already exists in the country.

But the major purpose of the sharp devaluation of the rupee was to halt a $3-4 billion annual erosion of foreign exchange caused by an organized racket which collects foreign exchange from Indian workers abroad to buy gold, and then sells the smuggled gold in India at a premium price (see **Table 1**). With the best intentions, in 1964 the government had imposed laws which made trading in gold illegal. In a land where gold is a currency of marriage, and where two tons a year is mined indigenously against an annual demand for 200 tons, the policy was a prescription for corruption.

The gold-smuggling operation that emerged—called the *havala* racket—was based in the Persian Gulf where the bulk of Indian workers earning dollars are concentrated. While a foreign worker's dollar would translate into exactly 18 rupees if remitted through an account at the State Bank of India, smuggled gold would fetch a 30% premium.

In July 1991 the rupee was devalued by 30%, and in March the rupee was made *partially convertible* (i.e., 60% of foreign remittances are valued at the market rate, and 40% are valued at the lower, official government rate). Simultaneously gold imports were allowed, albeit at a stiff customs rate. The *havala* racket was broken. Now those $3.4 billion in foreign remittances have begun to come into India through regular channels, and the gold price has crashed to such a low level that smuggling is no longer profitable.

Behind the reform effort

The Rao government's economic reform package begun in July 1991 is aimed at breaking down a structure built up by the bureaucrats, dishonest industrialists and businessmen, and money-hungry politicians over the past 20 to 30 years. India's Prime Minister Jawaharlal Nehru's first three five year plans, beginning in 1952, were designed to make India an industrial power. Influenced by Lenin's heavy industry model, Nehru paid little attention to the crucial elements of the economy—agriculture, and small and medium-sized industries. While Nehru's plans consolidated India's steelmaking, capital goods, and electrical equipment industries, the financing of the plans came mainly from expropriation of the agricultural surplus. Little in real terms was invested back into the traditional agriculture. In the mid-1960s when Nehru's daughter, Mrs. Indira Gandhi, took over as prime minister, India was already in the shadows of a massive famine.

U.S. Public Law 480 did prevent the large-scale loss of life, but the unscrupulous Lyndon Johnson administration saw in it an opportunity to put India into various binds. Early on, Mrs. Gandhi recognized the potential for negative political fallout from this, and the success of the Green Revolution technology in India saw the country through. During this period, Mrs. Gandhi nationalized the larger commercial banks to block off almost 75% of the country's liquidity for government use to finance priority sectors, and sidelined the private entrepreneurs. The Monopoly Restrictive Trade Practice Act (MRTP) was implemented in the 1970s to prevent large industrial houses from monopolizing credit and, potentially, political power, among other things.

While Mrs. Gandhi's policy was a success as far as India's agricultural development goes, the structure that she set up became the single largest source of corruption and disruption to the nation-building effort. Neither the bank nationalization nor the MRTP should have been debilitating—on the contrary. Yet, there was a failure of leadership in terms of follow-through, and, in implementation, the aims and purposes of these measures were sacrificed to political expediency.

Under the pretext of anti-monopoly concerns, viable projects were pushed aside, while non-viable projects, floated by the "right political faction," got approval. The knot between the bureaucrats, dishonest businessmen, and money-grubbing politicians became so tight that licenses were given to the "right people"—not in order for them to build something, but to prevent someone else from doing so. On

paper India showed a licensed capacity of such and such, while in reality it was much less. The result caused one renowned Indian politician to lament that "the British Raj has given way to the License-Permit Raj."

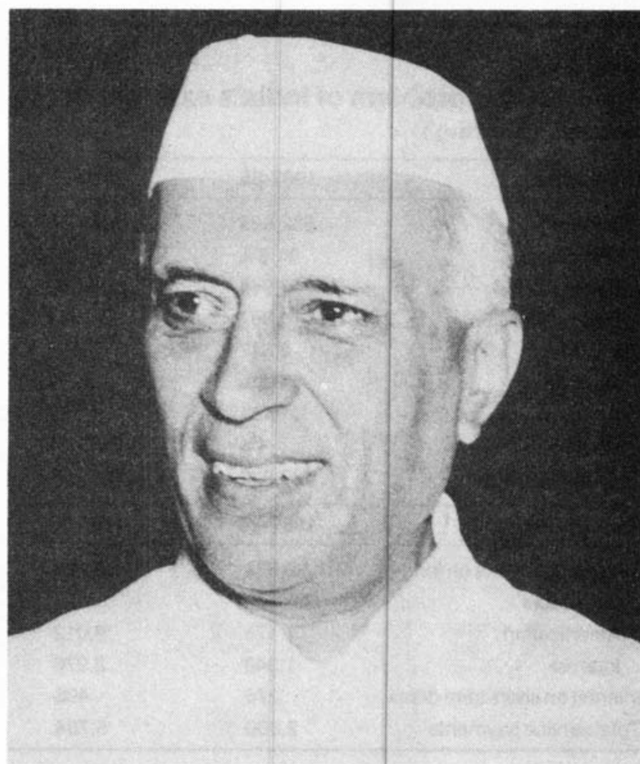
Productivity a major casualty

Productivity as a criterion for economic activity had no place in the "License-Permit Raj." The system was not guided by the efforts to facilitate productivity increases, and thus boost economic growth, by promoting modernization of industries: It was guided by the notion of "regulating." As Finance Minister Manmohan Singh put it in an early March meeting with foreign correspondents, the difficulty was a bureaucratic mentality of regulating *to prevent people from doing things,* not using power to *promote* social change. The task, he said, is one of political leadership.

By regulating industries such as cement and steel, for instance, and not enhancing their productive capacity, the government wittingly ushered in an underground market where both cement and steel were available at a higher price, unaccounted and untaxed. Employment potential was reduced and the economy was eroded. In fact, since the 1970s populist concessions induced by political expediency, elimination of long-term perspectives and general lack of direction chiefly undid what the plans and programs of the 1950s and 1960s promised. The Indian economy, after being readied for a takeoff, was rolled back into the hangar instead.

There were other corruptions, too, which impeded development. For instance, essential industrial equipment, many intermediate products, etc., were kept off the Open General Licensing (OGL) import list so that full protection could be given to the shoddy products manufactured by industrialists who greased the palms of the bureaucrats and politicians. Capital goods were put in the 150% tariff regime. Making the manufacturers of substandard products happy caused money to flow into India's political process in the form of huge amounts of unaccounted for cash. The public sector, the "commanding heights" in Nehru's vision, became a looting ground for politicians. It is this overall situation in the 1970s which gave rise to total anarchy, unprecedented inflation, imposition of the emergency, the rise of the Janata Party, and eventually the collapse of the system set up by Jawaharlal Nehru.

In 1980, when Mrs. Gandhi returned to power after three years in the opposition, she realized that this corrupt system would take India to the begging bowl. In fact, in 1981 India faced a foreign exchange crisis and borrowed $5 billion from the IMF. But, apart from setting up various commissions to look into the problem areas, such as the public sector, Mrs. Gandhi's understanding did not materialize into anything useful. Bogged down by political baggage of the past, a long association with the vested interest groups who had flourished by the system, and the crisis arising in Punjab kept Mrs. Gandhi tied down.



The late Prime Minister Jawaharlal Nehru. His five-year plans, beginning in 1952 aimed to make India an industrial power, but overreliance on a Leninist heavy industry model, blinded him to the crucial value of protecting and fostering agriculture and the small and medium-sized undertakings.

Change begins, haltingly

In 1985, when Rajiv Gandhi came to power with an overwhelming mandate from the people, he promised that India would usher in the 21st century as a country where technologies would flourish and the economy grow rapidly, providing assets equitably to the poor and rich. He also promised that the country would be taken from the vested interest groups and given back to the people. His five years, though not enough to make any final assessment, showed that the system was much too strong for him to dismantle in any direct way. Although he did not quite become a part of the system, he was at a loss as to how to deal with it.

But Rajiv Gandhi did bring about a significant change, because what he managed to accomplish in such a short time proved that, with determination, over the longer haul things could be moved. It was during this time that the economic reforms and liberalization process began. The effect of whatever reforms he was able carry out showed up in the execution of the Seventh Five Year Plan (1985-89). For the first time all the targets were met, and the country recorded a 6.2% annual growth rate—almost twice that achieved by either Mrs. Gandhi or Jawaharlal Nehru.

Rajiv Gandhi's success was not, however, an unmixed blessing. At the time the Seventh Plan was launched India's

TABLE 2

The growing problem of India's external debt

(millions $, annual avg.)

Gross debt	1982-85	1986-89
Long-term	$32,925	$56,484
Percent	91.3%	89.2%
Concessional	17,944	24,552
Non-concessional	14,981	31,993
Short-term	2,617	5,483
Percent	7.3%	8.7%
Other identified liabilities	491	1,302
Percent	1.4%	2.1%
Total identified debt	$36,032	$63,269
Service payments	**1982-85**	**1989-89**
Service payments on long-term debts	$2,524	$5,288
Amortization	1,176	3,012
Interest	1,348	2,276
Interest on short-term debts	276	496
Total service payments	2,800	5,784

TABLE 3

Change in trade deficit, April-Jan. 1990-91 and April-Jan. 1991-92

(in percentage)

	In rupees	In dollars
Imports	+7.36%	−21.3%
Exports	+32.3%	−3.09%
Exports to GCA*	+44.3%	+5.72%
Exports to RPA*	−28.3%	−42.3%
Deficit	−60.3%	−70.92%

*GCA: General Currency Area; RPA: Rupee Payment Area—the Soviet Union and eastern Europe.

foreign debt stood at $15 billion: By the time it was over, the foreign debt had risen to $60 billion-plus. Not that all of it was caused by the Seventh Plan, but there is no doubt that Rajiv Gandhi was much less frightened by a taboo against foreign borrowing than any of his predecessors, in part because he was self-consciously working to boost productivity and growth—the wherewithal to repay. In addition, India's debt, which is still overwhelmingly long-term low-interest obligations to governments or financial institutions, began to change its structure during these years, with short-term debt rising to almost 10% of the total—still a nominal fraction by comparison with, say, the Ibero-American debtors (see **Table 2**).

Despite the fact that the five years of the Rajiv Gandhi government did push India into a debt trap of sorts, studies show that the allegation that a flood of foreign imports was behind it is not true. A noted economist, Isher Judge Ahluwalia, has pointed out that, in fact, imports in U.S. dollars slowed from 19% of total imports per annum in the 1970s to 5% per annum in the 1980s. Non-petroleum imports in U.S. dollars also slowed down from 15 to 10% of total imports per annum. The ratio of total imports to GDP had increased sharply from 4% in 1970-71 to 10% in 1980-81. But the 1980s actually saw a major decline, so that the ratio at 9% in 1989-90 was lower in real terms than that of 1980-81 (see **Table 3**). Similarly, imports of raw materials, intermediate goods, and capital goods as a proportion of the value of output of the organized manufacturing sector had increased from 8% in 1970-71 to almost 10% in 1980-81, but fluctuated around a lower level of 9% during the 1980s.

In addition, on the positive side, an updated analysis of productivity and growth by Mr. Ahluwalia shows that after a long-term decline of 0.3% per annum in the 1960s and 1970s, total factor productivity in the 1980s (from 1980-81 through 1987-88) actually *rose* by more than 2% per year. (Total factor productivity growth, as Ahluwalia uses it, identified the contribution to an increase in output of influences other than increases in the factor input. It reflects not only technical progress but also better utilization of capacities, learning by doing, improved labor skills, etc.)

There was no reason for the mid-1980s debt buildup to be explosive. But it was intersected by the Iraq war and breakup of the Soviet Union, which had their different but very direct negative impacts on the Indian economy, and perhaps even more important, by two years of political chaos instituted by the V.P. Singh and Chandra Shekhar governments. In the end, investor confidence was eroded and foreign lenders shaken up. From being a perfectly viable borrower, India was put on credit watch. When the Rao government took over, India's foreign exchange reserves stood at $2.3 billion, a nominal month's import equivalent, down from $4.1 billion when V.P. Singh took over and announced to the dismay of all that he had "inherited an empty coffer" (**Table 4**).

The new industrial policy

While seeking loans from the IMF to alleviate the short-term crisis, the Rao government launched an industrial policy that centers around three basic premises.

First, industrial licensing, except in the case of coal, petroleum, defense equipment, hazardous chemical, drugs and pharmaceuticals, and a few other strategic areas, has been established to speed up investments, take power away from the bureaucrats and to reduce the generation of under-

TABLE 4

India's foreign exchange requirements, 1989-93

(billions $)

Year	1989-90	1990-91	1991-92	1992-93
1. Current account deficit	$8.3	$9.9	$6.0	$5.3
Capital account				
2. Principal payments	2.9	3.0	3.0	3.3
3. Increase in reserves	−0.9	−1.7	0.0	0.7
4. Financing need (1+2+3)	10.3	11.2	9.0	9.3
5. Normal capital flows	10.3	9.4	5.3	6.5
6. Exceptional need	0.0	1.8	3.7	2.8

Source: World Bank Report.

ground money. With this, 80% of industry has been released from the licensing noose. In a related move, areas reserved for the public sector have been halved, from 17 to 8.

Second, the link between the size of a company's assets and the concentration of economic power, a major bogey of the left, has been removed. The MRTP's definition of a "monopoly" as any company with assets above an arbitrarily low limit has acted over the years to prevent the development of economies of scale in Indian industry, and thus directly undermined economic efficiency and productivity. Now, the requirement of prior approval for capacity expansion or diversification has been explicitly dropped.

Third, conditions for foreign investment—viewed as advantageous because it reduces reliance on fixed-interest debt at the same time that it brings in new technology, marketing expertise, and modern management practices—have been significantly improved. Foreign companies are now allowed to hold a 51% equity stake in many high-priority areas, against 40% earlier, and procedures for entry have been simplified. The immediate impact of the industrial policy has been positive. A large number of projects were cleared and at least a half-billion dollars of foreign investment sanctioned (see **Table 5**).

But, the main issue, whether industry will pick up quickly or not, depends on the removal of a number of constraints that are still very much in place. The interest rate, which was dropped by 1% to 15% in the recent budget, remains too high for safe investment. Though the stock market has gone through the roof, as $3 billion rushed in, this has less to do with the state of industry than with the now-busted *havala* market.

For the de-licensing to really work, a series of other measures needs to be taken. Nearly 90% of India's industry is under central purview, but several crucial things, such as land, power, labor, water, and environment remain state subjects. Even if the government clears projects quickly, they get delayed at the state level, where the "License-Permit Raj" structure has yet to fall. The latter perpetuates corruption, too. During the Janata Dal rule, a top industrialist wanted to locate his soft drink bottling plant near Delhi, but the chief minister of the state demanded Rs. 10 million as a political donation to get water and power. Only recently, Prime Minister Rao pointed out that seven projects in the power sector have been held up for lack of environmental approval.

In addition, it is questionable whether the industrial policy framework by itself will bring in the investors either from home or abroad. The government has already committed itself to making the public sector more efficient and, for this

TABLE 5

Finance Ministry predictions on India's economic health, July 1991 and February 1992

July 1991 predictions for FY 1991-92	Reality	February 1992 predictions for FY 1992-93
Inflation rate in 1991-92 will be contained within 9-10%	Inflation remained at 12%	Budgetary measures will reduce inflation to 7%
Economy's expected growth rate to be 4%	Actual growth rate attained is close to 2.5%	GDP growth rate to pick up and attain 3.5-4%
Corporate taxes were raised as an emergency measure; promise to lower them later	Tax rate was never lowered and corporations forked out more in taxes in 1991-92	Budget for 1992-93 did not reduce taxes; promise to lower them later
Assurance of greater inflow of foreign investment in the form of equity	$500 million came in as foreign equity in 1991-92, twice the total of last 3 years	Trend to continue in future
Budget deficit will be reduced to 6.5% of GDP	Attained	Budget deficit will be further reduced to 5% of GDP
Farmers to be compensated by higher procurement prices due to hike in fertilizer prices	Procurement and floor prices were raised even before the procurement season	Fertilizer prices may go up this year too, as subsidy limited to Rs 50 billion (about $2 billion)

reason, has identified 54 public sector units that are non-viable. But the government will not lay off workers, and is still in the beginning stages of setting up and gaining labor support for a National Renewal Fund to retrain younger workers and provide the older ones with a so-called "golden handshake." Interestingly, this fund will also have the purpose of supporting technological modernization. The government is also talking to the trade unions about ways to enhance productivity in the public sector units. Investors are watching these developments, but it will be months before concrete results can be expected.

Pro-industrial trade policy reform

Meanwhile, the government also announced a new trade policy which has brought cheers from the industrial sector. The first phase of reform saw abolition of export subsidies and replacement of administered licensing of imports with an indigenous system of import entitlements linked to export earnings. These entitlements, called Eximscrips, were freely tradable, attracted a premium in the market, and could be used to import any item not on a restricted list. The Eximscrips system was a stepping stone to the partial convertibility policy announced in March. Now, exporters can also retain that 60% of foreign earnings the government will honor at market rates in a foreign exchange account. Sixty percent of export earnings will form the foreign exchange pool for imports. The government will take over the balance, 40%, at the official exchange rate for purchase of the essential bulk imports such as oil and petroleum products, vegetable oil, pharmaceuticals, and a few others.

In March, a five-year (1992-97) export-import policy which eliminated import and export licensing altogether was announced. While indicating that exports and imports will in the future be determined simply by "market forces," the current policy is careful to distinguish essential imports from non-essential imports. But instead of a myriad of negative and restricted lists, this is accomplished by means of the tariff structure. It is to be seen whether such simplification will work or not, and the government will have to monitor this closely and be prepared to take corrective steps. If import demand turns out to be inelastic for a number of other products—beyond oil, drugs and medicines, and the several others deemed essential and whose import is provided for by the government at official rates—the country could face an inflationary spiral and further imbalance of trade.

Although the government says that the new export-import policy is designed to enhance exports—a crucial element in solving India's foreign exchange problems in the long run—it is generally acknowledged that substantial incentives for export are not there.

The IMF-World Bank role

What exactly the role of the IMF-World Bank has been in launching the economic reforms is difficult to say. True, as lenders of the 18-month $2.2 billion standby arrangement which began in November 1991, the IMF has come into the picture directly. And, as a prospective "structural adjustment" lender, the World Bank has also become more involved. However, virtually all of the reforms have been recommended by one export committee after another set up by the Indian government since 1980. In fact, every government in recent years has promised to reduce the ballooning deficit and de-bureaucratize the economy. Rajiv Gandhi himself spoke out against bureaucrats and the web of licenses and regulations created to trap and kill all entrepreneurial dynamism. Moreover, even in the application of the specific conditionalities, there is considerable indication that it is not exactly swooning before the Bretton Woods inquisitors.

Since the standby loan was given for balance of payments support, the conditionalities associated with it are centered in fiscal and trade policy, and include the usual set of quarterly targets for such things as fiscal deficit, money supply growth, net bank credit to government and so forth. Among the immediate conditions that the IMF imposed was reduction of In-

Highlights of the industrial and financial policies

- Industrial licensing will be abolished for all projects except for a short list of industries related to security and strategic concerns, social reasons, hazardous chemicals or overriding environmental reasons, and luxury items consumption, such as televisions, VCRs, electronic entertainment, or white goods.
- The Monopoly Restrictive Trade Practice Act (MTRP) will be amended to remove the threshold limits of assets in respect of MRTP companies and dominant undertakings. Emphasis will be placed on controlling and regulating monopolistic, restrictive, and unfair trade practices.
- Approval will be given for direct foreign investment up to 51% foreign equity in high-priority industries. Such clearance will be available if foreign equity covers the foreign exchange requirement for imported capital goods.
- To provide access to international markets, majority foreign equity holdings up to 51% will be allowed for trading companies primarily engaged in export activities.
- A Special Empowered Board would be constituted to negotiate with a number of large international firms and approve direct foreign investment in select areas. This would be a special program to attract substantial invest-

dia's budget deficit from 8.4% of GDP to 6.5% by March 1993 (see Table 5). The government has already acquiesced to these demands, and both budgets show that clearly, though there is extensive debate over the extent to which the targets are being met by sheer fudging.

Interestingly, it was reported following the first review of the standby arrangement completed very recently that a number of targets, such as that for money supply growth, had not been met. The IMF had initially demanded that money supply growth for 1992-93 be held to 5%, compared to the actual of 19% against the target of 13% for 1991-92. "However, after negotiations, the IMF is understood to have agreed on a higher money supply target of around 11%," stated the reliable *Economic Times*. The IMF team was also reportedly concerned with the sharp fluctuations in the deficit level—namely the fact that it was brought down to the target on March 31, as required, and then promptly shot back up the following day! Again, discussions and explanations closed the issue.

Further, the *Economic Times* stated, controversial issues like the fertilizer subsidy reduction issue also came up during the review, "but the IMF officials are reported to have shown an understanding of the government's compulsions on this issue." When the government raised the (controlled) fertilizer price by 30% in July 1991, the political temperature in the farm belt shot up. Although in fact the fertilizer price rise should not have boosted food prices by more than 8% or so, the large farmers and grain merchants with hoarding capacity took the opportunity to drive grain prices up by more than 30%. The government back-tracked and instituted a dual price policy, allowing small and marginal farmers to continue receiving fertilizer at the 1980 price.

Complicated issues

There is no doubt the IMF representative got an earful on this subject. The fertilizer subsidy issue is complicated, and like other knotty problems has been discussed threadbare over the years with no political party willing to tackle it. It is clearly impossible to sustain the subsidy—which rose twelvefold over the decade of the 1980s and alone ate up 8%

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ment that would provide access to high technology and world markets.

- Automatic permission will be given for foreign technology agreements in high-priority areas up to a lump sum payment of Rs 10 million, 5% royalty for domestic sales, and 8% for exports.
- Portfolio of public sector investments will be reviewed with a view to focus the public sector on strategic, high-tech, and essential infrastructure.
- Public sector enterprises which are chronically sick and which are unlikely to be turned around will, for the formulation of revival and rehabilitation, be referred to the Board for Industrial and Financial Reconstruction.
- In order to raise resources and encourage wider participation, a part of the government's shareholding in the public sector would be offered to mutual funds, financial institutions, and general public.

The Rao government committed itself to some macroeconomic targets in a letter to World Bank President Lewis T. Preston:

- About 6% growth in GDP by the mid-1990s from 3.5% in 1991-92.
- An inflation rate not greater than 6% by 1995-96, compared to the expected 9-10% in 1991-92, and 7% in 1992-93.
- Building up of foreign reserves to about 2-3 months' imports in the next few years and attaining a level of $2.3-2.5 billion, worth about one month's imports, by the end of March 1992.
- Reduction of the external current account deficit to 1.5% of GDP by 1995-96, compared to about 3.5% of GDP in 1990-91 and 2.7% in 1991-92.

Narasimham Committee financial reform recommendations

- Structure of the banking sector to be revamped. Three or four large banks to become global in character.
- Eight to ten national banks with a network of branches to be engaged in universal banking.
- Local bank operations to be confined within a specific region.
- Rural banks to operate only in rural areas, functions based on profitability concerns.
- Government should remove disincentives and allow the more dynamic private banks to grow.
- Foreign banks should be allowed to open branches.
- Computerization of banks to be stepped up.
- Abolition of branch licensing; opening and closing branches should be left to parent bank.
- Duality of control over the banking system must go; Reserve Bank of India should be responsible for its regulation.
- Substantial liberalization of capital markets with no need for prior approval to new issues.
- Capital market to be opened up to foreign portfolio investment gradually.
- SLR requirement of banks to be brought down to 25%; progressive reduction in cash reserve ratio.
- Asset reconstruction, institution of capital adequacy and establishment of prudential norms.

of India's non-plan budget for 1991-92. And, it is clearly impossible to eliminate it.

What happened is that during the past decade fertilizer prices, particularly that of urea, were kept at the 1980s rate, thanks to the powerful farm lobby. During the same period the cost of inputs rose multifold, not the least of which was feedstock. Natural gas, which is explored and distributed by the government of India, is sold at about three times the international price to the domestic fertilizer industry. As a result, while the fertilizer price to the farmer is subsidized, the government-owned gas company shows a handsome profit.

In addition to the bloated price of natural gas, construction of fertilizer plants using outdated technology in the 1980s pushed up the capital cost of fertilizer production significantly. The system of fixing the subsidy to be paid to each plant on the basis of guaranteeing a stipulated return on capital invested encouraged plant managers—all government servants—to inflate their capital costs even further and pad working expenses. It is not unusual for these units to be operating at as low as 15-20% of capacity. In this respect, the fertilizer subsidy is nothing but a sleight-of-hand accounting process and a whole lot of inefficiency in the industrial sector.

So what? Why not let the subsidy grow? The obvious problem is that the government will have to allocate increasing sums of money away from other channels, including developmental, to meet the bill. Since India's fertilizer consumption, and hence production, has to go up sharply in the coming decade or so, the burden of subsidy could be astronomical. Moreover, it is not equitable. It is a windfall to the large, wealthy farmers, but the small, marginal farmers gain little. While keeping the urea price at the 1980 level, it should be noted, the farm lobby increased the procurement price of foodgrain during this period by about 85-90%.

But simply abolishing the subsidy doesn't solve the problem either, and may well create a much larger one if a decontrolled fertilizer price goes up so high that foodgrain production is affected and the procurement price rises too much. The government's present dual-price policy could lead to a significant amount of leakage as well as create distribution headaches, but there is little question that the fertilizer price will have to remain under control. A certain amount of fat, in tightening up the industrial side, can be cut to reduce the subsidy or keep it constant.

If the IMF orthodoxy hit the fan on the fertilizer subsidy issue, it cannot be said to have fared much better on trade issues. While allowing a lot more items to be imported, India has kept its tariff barriers rather high. This helps both industry and government, which depends significantly on the revenue generated by the customs duty. The highest import tariff remains as high as 110%, while capital goods still require payment of 60% tariff. The import regime at this point is a far cry from what one associates with World Bank-IMF norms, much less those of the U.S. Trade Representative. In fact, the latest report published by the latter summed it up: "While the United States welcomes the trade reforms instituted by the Indian government, India still has a long way to go."

More broadly, the IMF, and more particularly the World Bank, with which India has had a long involvement, have been pushing India to undertake reform of trade, financial institutions, and the public sector for a long time. The World Bank's latest in-house report, leaked in 1991, called for a sweeping reform of India's banks and financial institutions. The government set up an export committee, headed by former governor of the Reserve Bank of India, the country's central bank, M. Narasimham, to look into the financial sector's weaknesses. The committee's report called for a series of reforms, some of which are in common with the World Bank recommendations. However, so far the government has only partially implemented one of the many reforms suggested by the Narasimham Committee, and that was to lower the banks' Statutory Liquidity Ratio (SLR) from 38.5 to 30%. SLR refers to the money held by banks to buy the government's low-interest Treasury bills. By lowering the SLR, the government has made more credit available to private industry.

The Narasimham Committee flatly rejected the World Bank's recommendation to privatize the national banks, and instead suggested that dynamic private banks be allowed to grow alongside the nationalized system. In the industrial sector, too, the Rao government is not talking of privatization of public sector units. Instead, more as an exercise to reduce the budget deficit, the government plans to disinvest 20% of its shareholdings in the public sector companies. In no case will more than 49% of a given enterprise be divested. Some $1.2 billion was sold off in 1991-92, and a similar amount is slated for this year. The divestments are being made in the form of auctions to the government-owned financial institutions and government-owned mutual funds. At a later stage, private banks and employees will also be allowed to buy these shares.

The 1991-92 auction was carried out at a premium of almost 30%. Part of the proceeds went to reduce the budget deficit while the rest was put into the National Renewal Fund.

A deepening entanglement?

There is no doubt that pressure from the World Bank and the IMF to comply with their prescriptions, both narrow and broad, will continue and may even increase if India goes ahead to transform the current standby loan into a $6-7 billion Extended Fund Facility (EFF), as was expected in April. But the question is still up in the air. Though there is said to be a faction in the government pushing for the EFF option as a means to help keep the pressure on the government for fiscal discipline, the decision has now been put off until at least October.

The policies adopted by the government so far have created a great deal of confidence in the country. One of the major

sources of foreign exchange, the non-resident Indians based abroad have responded positively by depositing some $2.5 billion in Indian banks since the reforms were announced. Foreign remittances, helped by the breaking of the *havala* market, have increased significantly. Purchases of Indian Development Bonds abroad have already fetched another $500 million. There are expectations that, by allowing certain foreign pension funds to invest in the Indian capital markets, another $2-3 billion will come in annually. All of this adds up to the prospect of an additional $18-20 billion in foreign exchange inflows over the next three years, obviating any further borrowing from the World Bank or IMF. Finance Minister Manmohan Singh claims that India need an infusion of $3-4 billion annually in order to stay on course. Prime Minister Rao, during a recent visit to West Bengal, said that with foreign exchange reserves close to $5 billion, India does not have to go for the EFF. At this writing, reserves are reported to be well over $5.7 billion.

'Prosperity 2000': addressing the agricultural weak point

But if the Rao government hasn't invited the IMF and World Bank to destroy the Indian economy, neither is its reform program a panacea. There is no question that the economy must be freed from the corrupt "License-Permit Raj" that is sapping its strength. The balance of payments problem, not a major problem by any means other than in its immediate impact, can be resolved without much trouble, as has been demonstrated. But India's domestic market is massive, and, unlike South Korea, India will have to prosper by developing this market and improving the economic situation for all.

In this regard the area of greatest concern is agriculture, where economically 70% of the country's population is located. All-around improvement in agricultural productivity—which entails river basin development and overall water management, increased electrical power generation and distribution, better transportation and communication, better health services and a much wider and more effective education system—also requires a comprehensive plan for rainfed lands, which account for 70% of arable land and where productivity is awesomely low.

Without such a wide-ranging success in the agricultural sector, the economic reforms launched in the past year will be seen in retrospect as a mere patchwork, enabling India to survive, perhaps, but go no further. Happily, the government is addressing this problem, at least in large part, with discussion of a broad and bold proposal to transform Indian agriculture across the board from a subsistence mode to a profit-making proposition. The proposal, "Prosperity 2000," was developed by Dr. M.S. Swaminathan and C. Subramaniam, two of the prime movers in India's earlier, successful Green Revolution, and the Rao government is pushing ahead with it on a limited experimental basis in 12 different places in the country for a start.

The "Prosperity 2000" strategy aims at pushing the Green Revolution beyond the several crops and handful of states to which it was limited, and to directly address the need for bringing more crops under modern methods and establishing extensive processing and agro-industry works, which could provide more than 100 million new jobs in the rural areas themselves. The plan focuses on the development of select crops and agro-based industries with the largest technical, economic, market, and employment potential. Horticulture, aquaculture, sericulture, cotton, sugar, foodgrains, oilseeds, wasteland development, and dairy, poultry, and other commercial crops have been selected as thrust areas.

The plan proposes a 50% increase in horticulture and 100% increase in vegetable production to meet the full requirements of the population and produce a 25% exportable surplus by creating 200 model horticulture production and processing centers in both rainfed and irrigated areas throughout the country. This alone, Swaminathan and Subramanian claim, will create 3 million year-round jobs, raising 6 million rural families above the poverty line. Similarly detailed projections and plans have been made in the other thrust areas. The plan aims to raise foodgrain production from the present 177 million tons to 220 million tons, and to boost oilseeds output to 7.5 million tons, meeting domestic demand fully to completely eliminate reliance on costly imports. The plan also proposes reclamation of 8 million hectares of wasteland to meet the demand for industrial wood and provide sufficient animal feed to sustain the dairy development program.

The principal vehicle of this program will be the newly established Small Farmers Agribusiness Consortium (SFABC), which will mobilize small and marginal farmers at the grassroots level for involvement in a combined marketing, production, and processing plant in their area. The consortium was set up as an autonomous corporate entity funded by the Reserve Bank of India, the National Bank for Agriculture and Rural Development, and the Industrial Development Bank of India, and will include representation from various development boards dealing with individual crops and public sector agencies dealing with agriculture, as well as private companies, banks, scientific organizations and farmers' associations. The consortium will function on the principles of economic efficiency, environmental soundness and social equity, and will organize 12 major projects in 1992-93 in different parts of the country.

"The program will be expanded as we gain experience," Finance Minister Manmohan Singh told the Parliament in his budget address. "We must begin a new chapter in our agricultural history where farm enterprises yield not only more food, but more productive jobs and higher income in the rural areas."