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Prospects of Economic Reforms in India

Dr. Alok Sheel

Counsellor (Economic), Embassy of India

Washington DC, USA

Prospects of Economic Reforms in India

- Overall Impact of economic reforms so far
- Disaggregated impact of reforms
- Second generation economic reforms
- Prospects

Overall Impact of 10 Years of Economic Reform

- Growth Rate Increased
  - From an average of 5.6% in 1980-91 to 5.9% in 1992-2003
  - Uneven across States: western and southern States (AP,Kar,TN,MAH,Guj & Raj) grew at ‘East Asian Tiger’ average rates of 6.8% between 1993-4 & 2001-02
- Poverty decline accelerated **(Indian Planning Commission)**
  - 1983/84: 44.5% BPL
  - 1993/94: 36% BPL
  - 1999/00: 26.1% BPL
- Macro-economic stability
  - Stable interest, inflation and exchange rates

Disaggregated (sectoral) Impact

Industry	Disappointing
Pvt.and foreign Investment	Below potential
Tariff rationalization	Mixed
Exchange controls	Major success story
Tax reform	Disappointing results so far
Financial sector	Good progress
Services	Robust
Agriculture	Largely unaffected
Infrastructure	Mostly disappointing
Social sector	Disappointing
Fiscal reform	Major failure

Industrial De-licencing

- **<u>Outcome disappointing so far</u>**
  - After initial spurt, average industrial growth rate declined from 7% in 1980-91 to 6.3% in 1992-2003
  - Constraints still to be addressed:
    - Labour inflexibilities
    - SSI de-reservation incomplete
    - Weak infrastructure
    - Governance
    - Tax harmonization across States
    - Trade Policy

Opening up investment to private sector

- **Mixed picture**
  - Growth in private domestic and foreign direct investment has simply compensated for the decline in public investment.
  - Investment in knowledge-based industries and services has zoomed.
  - Reasons for failure to realise potential same as in the case of Industrial de-licensing.
  - Level of private investment inadequate to absorb growing population, especially in rural areas, where unemployed work force rose from 1.2% in 1993-94 to 1.5% in 1999-2000.

Sharp reduction and rationalization in Customs Tariffs

- **Mixed outcome**
  - Foreign Trade/GDP increased from about 17% in early nineties to about 25% at present. (China: over 40%)
  - No sustained export boom: Average annual export growth rate increased from 9% in 1988-1993 to 11% in 1993-2003. Merchandise Trade deficit relatively stable at 3-4% of GDP
  - Export growth rates below potential on account of relatively high tariffs and depressed industrial growth and investment.

Float of Rupee & reduction in Capital Controls

- **<u>Major success story</u>**
  - Relatively stable real exchange rate.
  - Huge capital inflows and pile-up of reserves. (from $ 1 Billion in 1991-92 to over $ 90 billion at present)
  - Market determined exchange rate huge incentive for IT exports.
  - Excellent response to opening up of Insurance sector which is now growing at double digit rates.
  - Surge in inflows has potential for instability: money-supply & exchange rate appreciation.

Rationalisation of tax rates and administrative regime

- **Overall disappointing so far**
  - Significant rationalization of rates.
  - Tax administration yet to be revamped.
  - Tax-GDP ratios dipped slightly from around 15.5% pre- reform to about 14.5% at present.
    - Direct taxes increased
    - indirect taxes decreased
  - Introduction of VAT still on drawing board.
  - Inter-State commerce hampered by toll taxes: weak economic integration

Financial Sector

- **Good progress**
  - Movement from regulated to market determined interest rates.
  - Saving rates climbed from 20% of the GDP in 1980-91 to almost 25% at present.
  - Successful opening of Insurance sector to private and foreign investment. Major pension reforms introduced.
  - Banking and capital markets reform:
    - NPAs reduced and prudential norms enforced: gross and net NPAs to total advances reduced from 14.4% & 7.3% in 1997-98 to 9.5% and 4.5% in March 2003
    - Stock exchanges computerised and settlement periods down to T+2.
  - Unaffected by financial instabilities in other developing countries in Latin America, East Asia and Eastern Europe.

Services

- **Robust growth**
  - Average annual growth rate rose from 6.6% in in 1980-91 to 7.5% in 1992-2003
  - The engine of growth of the Indian economy in the post reform period: knowledge-based and IT services growing at about 30% annually.
  - Exports of services major source of capital inflows and current account surplus. Depreciation of exchange rate major incentive, and successful telecom reforms and investment major stimulus.

Physical Infrastructure

- **Mostly disappointing**
  - Telecom sector the major success story fuelled by cellular technology. Teledensity
    - Rose from <1 in 1995 to 7 in 2003 (2 yrs ahead of target)
    - Expected to rise to 15 by 2006 (4 years ahead of target)
  - Private management of Ports has reduced ship turnaround time.
  - Golden quadrilateral north-south highway corridors progressing fast
  - Power sector the most disappointing – public-private partnerships have not worked as expected. Impact of new central ‘Electricity Act 2003’ still to be felt.
  - Railways untouched by reform
  - Air transport sector has seen very limited opening up.

Social Infrastructure

- **Disappointing**
  - Shifting public assets and investment from commercial activities to core sovereign responsibilities in health and education was a major driver of the reform impulse. This shift has still to take place.
  - Public expenditure on health and education declined as a percentage of the GDP/SDP in both the Centre and the States:
    - Centre: 0.6% in 1980-82; 0.85% in 1990-92; 0.75% in 1998-99
    - States: 6.96% in 1980-82; 7.76% in 1990-92; 6.2% in 1998-99
    - High levels of illiteracy (35%) & school drop-out (67% in classes I-X), maternal & child mortality, lack of access to health care and poverty persist. (**World Bank**: 39% earned less than $ 1 per day at PPP, the international poverty benchmark)

Agriculture

- **Largely unaffected by Reform**
  - Over 70% of population, including majority of poor, dependent on agriculture, free trade and growth in agriculture rather than in industrial goods, more likely to alleviate poverty. Rural unemployment increasing.
  - Potential to become a major international player in agriculture:
    - Large area under agriculture – same as the United States
    - Inherently competitive as agricultural subsidies far lower than European Union, USA, and OECD countries.
    - induction of modern technology/biotechnology will make India even more competitive because of low energy input-output ratios.
    - water security in areas of dry agriculture (only 40% irrigated): still monsoon dependent.
    - institutional mechanism for consolidation of small holdings
    - Investment in agro-processing and post harvest technology
    - capital and infrastructural investment to compensate for decline in public investment.
    - Lifting restriction on movements of produce and price interventions
    - Opening up of international trade in agriculture

Restructuring the Public sector

- **<u>Major disappointment</u>**
  - Consolidated FD of Centre and States static around 8% of GDP leading to ballooning public debt.
    - Centre's FD declined from 6.7% of GDP in 1980-91 to 5.1% in 1992-2003
    - States' deficit increased from 2.9% to 3.4% during the same period.
    - Public debt/GDP rose from about 60% in 1991-92 to over 70% in 2001-02.
    - Fiscal deficit absorbed domestically, as incremental public debt mostly domestic.
    - Little macro-economic evidence of crowding out so far.
  - Privatization and Civil service reform progressing slowly.
  - Surplus for generating infrastructural investment not available

Second Generation Reforms

- Aligning customs tariffs to global norms
- Making Labour laws more flexible
- Complete de-reservation for SSI sector
- Completing tax reforms
- Removal of equity caps in financial sector
- Investor friendly infrastructure policy, esp. in Power, Railways and Air Transport
- Major fiscal adjustment
- Agriculture
- Substantial hike in social infrastructure investment.
- Improving governance, enforcement & regulation.

Prospects

- Balance sheet of economic reforms on the whole encouraging.
- Disaggregated sectoral impact shows that full potential still not attained in the absence of ‘second generation’ reforms.
- Higher growth trajectory (8%) necessary to absorb growing population productively.
- These reforms more challenging politically, and mostly in the domain of State governments.
- India’s target growth rate of 8% (achievable-China) contingent on:
  - second generation reforms to boost industrial and agricultural growth rates
  - Fiscal reform and public infrastructural investment
  - Reform in northern and eastern States that grew at an annual average of just 4.5% between 1993-94 & 2001-02(Orissa & undivided UP,MP & Bihar)
- ***McKinsey Global Institute*** Report of 2001: removal of three main barriers can add 4% a year to India’s growth rate: multiplicity of regulations in product markets, distortions in land market & widespread government ownership