nothing but factor prices received by households. These factor prices constitute the income of households which they spend on goods and services produced by firms. There is thus a circular flow of money from firms to households and from households to firms. In other words, national income is equal to national spending.

Keynes's Criticism Of The Classical Approach

The classical economists assuming the validity of Say's Law had contended that the rate of interest and the flexibility of wage rates ensured economy's equilibrium only at full employment. In their opinion voluntary and frictional unemployment were consistent with full employment level of income. They asserted that any situation of involuntary unemployment could exist only temporarily while the forces inherent in the economy were active to restore full employment. This theory was challenged by Aftalion in France much before the publication of Keynes's *General Theory.* In the United States, the insitutionalists — Veblen, Commons, Mitchell and their followers — were highly critical of the classical approach. As a matter of fact, Say's Law was subjected to serious questioning. But as A. H. Hansen has aptly stated, ***"no one succeeded in making a theoritical case against the basic premise that the price system tended automatically to produce full employment. Two powerful defences were invariably erected against anyone who challenged this fundamental conception: (1) that a flexible interest rate would ensure equality between saving and investment at full employment; (2) that in a system of flexible wages and prices, an adequate market would, except for temporary disturbances, be assured."***[13]

If one were to disprove classical theory, one would be required to demolish these two 'powerful defences' of the classical theory and this is precisely what Keynes did.

1. As far as the first 'defence' of classical theory is concerned, ***Keynes argued that there is no assurance that intended saving will equal intended investment at a level ensuring full employment.*** The people and firms who save are often not the people and firms who invest, and they often have quite different motivations. For example, a considerable amount of money is saved by families who want to put something aside for rainy day. According to Keynes, the crucial determinant of saving is not the interest rate but rather the level of disposable income. On the other hand, a considerable amount of investment is done by firms that are interested in increasing their profits by installing new plants and machinery. A substantial part of this investment is relatively insensitive to change in the interest rate and depends heavily on, what Keynes called, the "animal spirits" of business. Finally, Keynes felt that technical factors at times might prevent the interest rate from falling enough to bring about an equilibrium between saving and investment. For all these reasons, he rejected the classical view of the interest rate as the equilibrator of saving and investment decisions. Thus the first 'defence' of the classical theory of employment stands demolished.

2. ***Keynes and his followers argued that the assumption of classical economists that prices and wages are flexible is 'unrealistic'.*** In the real world, there are a large number of monopolistic and oligopolistic firms operating and they effectively thwart any declining trends in prices. The trade unions fight hard to avoid cuts in wages. Modern-day governments also adopt a number of price support programmes and enforce minimum wage laws in a bid to fulfil their social responsibilities. On account of all these reasons, wages and prices are inflexible in the downward direction and thus the classical assumption of wage and price flexibility seems rather unrealistic. ***Therefore, the classical 'self correcting' mechanism fails to operate.***

In any case, argued Keynes, ***manipulations of wage rates could not be depended upon to increase employment.*** This is due to the reason that it is money income of wage earners which *mainly* determines the total demand for consumers' goods. Thus if money wage rates are reduced, the level of demand will also fall. This could reduce the incentive to invest leading to a fall rather than an increase in employment. According to Keynes, therefore, ***manipulation of demand is a far more effective way to increase employment rather than the manipulation of wage rates.*** Thus Keynes effectively demolished both the 'defences' of the classical theory and proved convincingly that the self-correcting mechanism which is in-built in this theory does not operate. Hence to tackle the problem of umemployment and to pull the economy out of depression he called for aggressive government intervention in a bid to boost aggregate demand.

Given the circumstances that prevailed during the years of the Great Depression in the 1930s, most of the economists who were disillusioned with the classical theory became convinced that Keynes was fundamentally correct. Propelled by Keynes, the conscious and forceful use of the government's power to spend and tax has become an important tool of macroeconomic policy over the last six decades.[14]

Revival Of Supply-Side Economics

During three and a half decades period from World War II untill 1980 the focus of economic policy in

the western countries was on the need to deal with the problems of unemployment and inflation. In this period economists generally favoured tax cuts or expenditure increases or both to reduce unemoplyment. Tight monetary and fiscal policies were recommended to control inflation. ***Towards the end of the 1970s it was commonly felt that economic policy was too much oriented toward the management of aggregate demand.*** It was the period when disenchantment with demand-side economics had begun. Many economists in the USA were convinced that excessive concerns with short-run actions could threaten the long-run growth potential of the economy. Hence, for controlling inflation the revival of more traditional policies of balancing the budget was considered necessary by some economists. Some others known as the exponents of supply-side economics downplayed the role of demand managment, emphasised incentives for people to work and save and recommended large tax reductions to accelerate economic growth and reverse slowing productivity growth. The most prominent among the proponents of this approach were Arthur Laffer, Paul Craig Roberts and Norman True. Reaganomics and Thatcherism represented supply-side economics from 1979 to 1990. Both in theory and practice proponents of supply-side economics have taken a wide variety of positions, still it is not difficult to see that there are three central features of this approach. The central features of supply-side economics can be stated as follows:

1. Retreat from the Keynesian demand management approach.
2. Emphasis on the role played by incentives and supply effects.
3. Advocacy of large tax reductions.

1. Retreat from the Keynesian approach. The Keynesian economics holds that, in the short-run, national income and employment are determined primarily by aggregate demand. Moreover, for tackling the problems of inflation and unemployment monetary and fiscal measures should be adopted. However, during the 1970s this approach failed to provide an answer to the phenomenon of stagflation. Economists thus in a large number became disenchanted with the Keynesian approach. In 1981 Martin Feldstein of Harvard University published an influential article in which he criticised demand-oriented policies.[15] His contention was that there should be greater emphasis on factors such as increased saving and investment and reduction in taxes on capital income, as they would increase growth potential. In his opinion, macroeconomic policies should be oriented to long-run economic growth rather than short-run economic stabilisation.

2. Emphasis on the role played by incentives. A second central idea of supply-side economics was the key role played by incentives in increasing aggregate supply. Supply siders argued that certain types of tax cuts would ensure adequate returns to labour, capital and entrepreneurship. Keynesians in their concern with demand management overlooked the adverse impact of excessively high tax rates on incentives and it is this reason why they failed to realise that high tax rates have a tendency to decrease aggregate supply. Samuelson and Nordhaus have aptly summarised the second theme of supply-side economics as follows: "In the context of aggregate supply-and-demand analysis, lowering tax rates would raise the post-tax return to capital and labour; higher post-tax returns would induce greater labour and capital supply, alongwith higher rates of innovation and productivity growth; and the increase in inputs and innovation would increase the growth of potential output and thereby shift aggregate supply to the right."[16]

The supply-side policies, however, did not have the expected impact on the US economy during the 1980s. The supply-side economists had predicted that their policies would lead to around 4.8 per cent per annum growth in real GNP for four years and thus economic recovery would be swift. But the actual growth rate averaged only 2.5 per cent per annum belying the tall claims of supply-side economists. The critics of supply-side economics thus asserted that the supply-side policies had little impact on potential output growth in the USA in the 1980s.

3. Advocacy of large tax cuts. The final theme of supply-side economics has been its advocacy of large tax cuts. In Chapter 12, in our analysis of the multiplier process we have explained how taxes affect aggregate demand and national income. Supply-side economists argue that Keynesians have overemphasised the role of taxes in affecting aggregate demand. According to supply-siders, particularly Arthur Laffer, high tax rates reduce tax revenues. The Laffer-curve proposition suggests that high tax rates make the tax base narrow because of a lower level of economic activity resulting from their adverse impact on incentives. Many Keynesians and even some supply-side economists have rejected the Laffer proposition rather contemptuously.

Supply-side economists have made a variety of recommendations on tax cuts. A sample of their long list of recommended tax cuts is as follows:

1. Lower personal income tax rates.
2. Reduce taxes on income from savings.
3. Reduce the tax burden on corporations.
4. Provide tax credits for Research and Development.

Appraisal of Supply-Side Economics

Supply-side economics has always been controversial. Critics generally do not question the basic approach that tax cuts improve incentives. They nonetheless argue that supply-side economists over-emphasise the beneficial effects of tax cuts and overlook even obvious side effects. The main objections to supply-side tax cuts are as follows:

First, supply siders are unnecessarily too optimistic about the magnitude of tax cut effects. Theoretically it looks sound that tax cuts would make working attractive financially, while in practice, people may decide to work for fewer hours as they are able to afford the goods and services they want even when they work less. Most of the statistical evidence does not support the optimism of supply-side economists. It indicates that tax reductions in the past have resulted in only modest increases in labour supply or household savings.

Secondly, supply-side economists ignore the effects of tax cuts on aggregate demand which according to critics is without any justification. It is very much legitimate to expect that individuals will spend more when personal income tax is reduced. Similarly a reduction in corporation tax may encourage business firms to expand their capacity for which they will demand more investment goods. Both these possibilities are real and their outcome may be a rise in price level.

Thirdly, supply-side corporation tax cuts aim at greater business investment or R&D. But the benefits of such activities are available only in the long period because expansion of capacity rarely materialises in the short run. It seems certain that the expenditures on investment goods are incurred much before the capacity expansion takes place. This implies that supply-side tax cuts will have their primary effects on aggregate demand in the short run. Effects on aggregate supply will follow in the long run.

Fourthly, claim of the supply-siders that tax cuts would ultimately boost up government revenue by stimulating economic activity turned out to be false. In the USA, tax revenue fell sharply as a result of tax cuts and this in turn led to an increase in the federal budget deficit during the 1980s.

Fifthly, supply-side economic policies brought down inflation in the USA in the early 1980s at a high cost in terms of an increase in unemployment and a steep fall in the average rate of growth of potential output.

Finally, most supply-side policies increase income inequality. Baumol and Blinder remark," while raising the incomes of the wealthier members of our society may not be their primary aim, most supply side cuts cannot help but concentrate their benefits on the rich simply because it is the rich who own most of the capital."[17]

To sum up, the experiment in radical supply-side economics did not show much promise and as a result this approach to economics gradually faded in the 1990s. Presently there are not many takers of supply-side policies.

NOTES

1. Michael Parkin, *Macroeconomics* (Reading, Massachusetts; Addison-Wesley Publishing Company, 1990), p. 307.
2. *Ibid.,* p. 307.
3. John Maynard Keynes, *The General Theory of Employment, Interest and Money* (London : Macmillan and Co. Ltd., 1936), p. 295.
4. *Ibid.,* p. 296.
5. *Ibid.,* p.295.
6. *Ibid.,* p. 207.
7. James Tobin, "Liquidity Preference and Monetary Policy," *Review of Economics and Statistics,* Vol. 29, May 1947, pp. 124-131.
8. David E.W. Laidler, *The Demand for Money: Theories and Evidence*, (Bombay, 1972) p. 98.
9. Kenneth Boulding, *Economic Analysis*, Vol. II (New York : Harper & Row, 1966), p. 78.
10. Paul A. Samuelson and William D. Nordhaus, *Economics* (New York : McGraw-Hill, Inc., 1992), p. 643.
11. Edward Shapiro, *Macroeconomic Analysis* (New York: Harcourt Brace Javonovich. Inc., 1978). p. 307.
12. F.S. Brooman, *Macroeconomics* (London : George Allen and Unwin Ltd., 1967), p. 288.
13. A.H. Hansen, *A Guide to Keynes* (McGraw-Hill Book Company, Inc., International Student Edition, 1953), p.6.
14. Keynes's approach known as demand side economics has been discussed at length in Chapters 9, 10, 11, 12.
15. Martin Feldstein,"The Retreat from Keynesian Economics", *The Public Interest* (Summer 1981), pp. 92-105.
16. Paul A. Samuelson and William D.Nordhaus, *op. cit.,* p.561.
17. William J. Baumol and Allan S. Blinder, *Economics — Principles and Policies* (Orlando : Harcourt Brace and Company, 1994), p. 706.

PART — II

Environment of Business in India

UNIT 4

Indian Economic Environment

17. Broad Profile of the Indian Economy and the Macro Economic Scenario
18. Economic Reforms and Liberalisation
19. Globalisation
20. International Institutions — The IMF and World Bank
21. GATT and WTO
22. Infrastructure and Business
23. Agriculture and Business

"We need to realise that economic prosperity for a nation is not about Economics alone. A nation cannot be run like a Departmental Store with the only motive of profit maximisation. Economic prosperity encompasses social development, which is crucial to the soul of a nation."

—Arindam Chaudhari, In
The Great Indian Dream, p. 21

CHAPTER

17 BROAD PROFILE OF THE INDIAN ECONOMY AND THE MACROECONOMIC SCENARIO

India — An Underdeveloped Economy
• Low Per Capita Income • Inequitable Distribution of Income and Poverty • Predominance of Agriculture • Rapid Population Growth • Unemployment • Scarcity of Capital • Technological Backwardness • Lack of Enterpreneurs
India — A Developing Economy
• National Income Trends • Structural Changes
India — A Mixed Economy
Macroeconomic Scenario
• Economic Growth Since 1997-98 • Erratic Industrial Growth • Saving and Investment Growth in Recent Years • Prices and Inflation • Fiscal Imbalance • Monetary and Capital Market Developments • External Sector

In this chapter we propose to present a broad profile of the Indian economy as it will help us in understanding the scope for business activity in the country. The Indian economy is often characterised as underdeveloped which means that the national income being low in the country, the size of market is rather limited. Hence, a business firm cannot plan to expand its activities easily. Unlike a firm in a developed country, it will always face a demand constraint. The Indian economy, however, no longer suffers from stagnation as it did under the British. The country's economy is now in the process of development which is continuously creating opportunities for increased business activity. Having missed the opportunity to develop along the capitalist path during the colonial period, after Independence India opted for a planned capitalist development and accordingly built-up a mixed economy.

In our analysis of the broad profile of the Indian economy in the following pages we shall concentrate on the following characteristic features of the Indian economy:

- The Indian economy still remains underdeveloped.
- Having succeeded in coming out of the 'low level equilibrium trap', the Indian economy has been growing both in terms of an increase in its per capita income and in terms of structural changes.
- From its pre capitalist form, the Indian economy has evolved into a mixed economy.

INDIA—AN UNDERDEVELOPED ECONOMY

Whatever be the criteria, ***the Indian economy is presently an underdeveloped economy.*** Almost all important characteristic features of an underdeveloped economy are present in the Indian economy even after more than sixty years of Independence. Underdeveloped economy is primarily an agricultural economy, as 60 to 70 per cent of the country's population seeks employment in agriculture. In an underdeveloped economy not only the per capita income is low but the rate of capital accumulation is also low. Demographically these economies are backward, as life expectancy at birth is low and the population grows rapidly. Widespread unemployment is a normal feature. Not only technological knowledge is inadequate in an underdeveloped economy, but lack of Schumpeterian enterpreneurs also operates as a growth arresting factor.

Low Per Capita Income

Compared with the developed countries of the West, the Indian economy was appallingly poor in the early 1950s. On the basis of per capita income, India was among the few poorest countries in the 1950s. This poverty and backwardness, India had inherited from the colonial rule. After Independence the government wanted to give a 'big push' to the standstill economy and for this purpose, it employed the technique of 'democratic planning'. With the efforts of the government some development has indeed taken place during the six decades of planning, but India still remains one of the most underdeveloped countries in terms of per capita income. One can have some idea of the plight of the people in this country from the fact that only countries like Nigeria, Kenya, Tanzania, Zambia, Ethiopia, Bangladesh and Nepal are poorer than India and the per capita income in the rest of the Third World is higher than that in this country. The economic distance between the most developed countries and India has also increased over the years. ***In 2006 India's per capita income was as low as $ 820. It was only a little more then one-fiftieth of the USA's per capita income.***

Inequitable Distribution of Income and Poverty

The distribution of income and wealth in India is inequitable. This is clearly reflected in inequalities in the household expenditure. In 1999-2000, according to the *World Development Report 2005,* while the lowest 20 per cent households accounted for 8.9 per cent of the aggregate household expenditure, the share of top 20 per cent in it was as large as 41.6 per cent. In the middle category 60 per cent households at modest level of living accounted for 50.5 per cent of the aggregate household expenditure[1]. From the point of view of the modern business firm the lowest 40 per cent households with their meagre purchasing power are not relevant. In fact, even the middle category households with modest income will not create as much demand for industrial products as the highest 20 per cent households.

The problem of mass poverty is a corollary to income inequalities. Poverty has been a known fact of life in India. The Planning Commission itself in the Sixth Five Year Plan 1980-85 acknowledged the fact of widespread poverty in the country. The Plan document stated that using norms of calorie consumption, the percentage of population below the poverty line in 1979-80 was estimated at 50.7 per cent in rural areas and 40.3 per cent in urban areas. For the country as a whole the percentage of poor was as high as 48.44.[2]

According to the Planning Commission, the overall percentage of the people below the poverty line had declined to 36.0 per cent in 1993-94 while the incidence of poverty was 37.3 per cent in rural areas and 32.4 per cent in urban areas.[3] Thus there was a significant decline in the incidence of poverty during the 14 years period prior to implementation of liberalisation measures. Now the latest estimates of incidence of poverty are available for 2004-05, which according to Mixed Recall Method reported that the incidence of poverty was 22 per cent. These estimates are based on the data provided by the 61st Round of the NSS. However, these estimates are not comparable with the earlier estimates due to change in methodology. The latest comparable estimates are available from 54th Round of the NSS for January 1998—June 1998 which show that 44.9 per cent population in rural areas and 31.6 per cent population in urban areas was below the poverty line.[4] These estimates show that since the late 1970s there has been a decline in incidence of poverty. Nevertheless, ***the percentage of population below the poverty line is still quite high. This is an alarming situation from the point of view of the business because even after 61 years of Independence, about one fourth of India's population neither has much capacity to contribute to capital accumulation nor to create large demand for industrial goods.***

Predominance of Agriculture

Occupational distribution of population in India is not at all satisfactory and clearly reflects economic backwardness of the economy. In 1951 about 70 per cent of the population of the country was dependent on agriculture for its subsistence. Since then very little change has occurred in this regard. Even when we consider the working population we find that 64.8 per cent of working population was employed in agriculture in 2001, as against 69.7 per cent in 1951. Thus the dependence on agriculture seems to have declined only marginally. In developed countries importance of agriculture is much less. For instance, while 65 per cent of India's working population seeks employment in agriculture, only 2 per cent of the USA's working population is engaged in agricultural operations.

A second indicator of the predominance of agriculture in the Indian economy is the proportion of national income originating in this sector. In 2006-07 agriculture and allied activities contributed 18.5 per cent of the Gross Domestic Product. This is indeed less than the share of agriculture in Gross Domestic Product in 1950-

51 (when it contributed more than 55 per cent). But this is not a big achievement considering the fact that about six decades of planning were devoted to reduce working populations dependence on agriculture. Even now the reliance on agriculture in India is far greater than in some other Third World countries such as Argentina, Malaysia, Thailand, Mexico, Brazil, and Republic of Korea. In these countries agriculture now accounts for 10 per cent of the GDP or even less.

The Indian economy thus is essentially agrarian. In the agricultural sector productivity is low and, as a result, a large number of farmers have virtually little purchasing power to buy industrial goods. However, when agricultural sector performs well due to good monsoons the increased spending by the peasant households results in increased demand for manufactured goods and the industrial sector in response registers a high growth rate. Lately with the opening up of the economy, agriculture has suffered a setback.

Failure of the agricultural sector on production front even now causes recession in the industrial sector. It is this reason why the growth and prosperity of agricultural sector in this country is a precondition for the growth and viability of the business. This quite often is not appreciated. However, the 1990s have found the rural potential being treated with far greater seriousness. It is no longer just the other 'market', secondary to urban India.

Rapid Population Growth

Life expectancy at brith in India was 64 years in 2006 as against 73 years in middle income economies. This should have resulted in low rate of population growth. However, over the years population in India has been growing at a fast rate. In April 2006, India's population was 1,100 million as against 361 million in 1951.

Over the 50 years period the rate of population growth was over 2.0 per cent per annum and since 2000-01, it has been at the rate of 1.5 per cent per annum. On present indications there may not be any significant decline in this rate of population growth in the future. This demographic situation is a major constraint on the growth of business.

Firstly, due to rapid population growth the "the requirement of feeding additional numbers compels the use of resources in low return agriculture rather than higher return manufacturing."[5] This allocation of resources arrests growth of effective demand and thus adversely affects the size of market which no marketing strategy or skill can expand. Secondly, the rapidly growing pressure of population in the period of slowly growing employment opportunities often restricts the freedom of the management to adopt the most sophisticated production technologies.

Unemployment

Widespread unemployment is probably the most striking symptom of inadequate development in India. According to 61st round of the NSS-current daily status unemployment rates in 2004-05 by gender and rural urban location are as given in Table 17.1.

TABLE 17.1. Unemployment by Gender and Rural-Urban Location(1993-94 and 2004-05)

	Current Daily Status Unemployment Rates (per 1000)			
Year	*Rural males*	*Rural females*	*Urban males*	*Urban females*
1993 -94 (50th Round)	56	56	67	105
1999-2000 (55th Round)	72	70	73	94
2004-05 (61st Round)	80	87	75	116

***Source*:** NSS, 61st Round Survey conducted on employment and unemployment .

The 61st round of the National Sample Survey shows that unemployment increased between 1993-94 and 2004-05 as per the usual status. Using the daily status figures which are a more rational measure of the level of employment, the unemployment rose by 5-7 per cent between 1993-94 and 1999-2000. From the figures of unemployment rates provided in Table 17.1 it is clear that unemployment situation worsened during the period 1993-94 to 2004-05 in all the four population segments *viz.* rural males, rural females, urban males and urban females. ***Thus employment situation did not improve in the period of liberalisation. Economic growth was mostly jobless. Moreover, a large number of workers lost jobs as a consequence of downsizing of industrial units.***

The nature of unemployment in India is, however, not the same as in developed countries. Most of the unemployment to be found in the developed countries of the West is cyclical. In contrast, unemployment in India is chronic and results from the structural defects in the economy. People in a large number in the countryside do not have adequate work throughout the year and many of them suffer from open unemployment for long periods. According to Ragnar Nurkse, in underdeveloped countries like India, people suffer from disguised unemployment in agriculture. Presently the problem of urban unemployment in India has assumed two forms. First, the failure of the industrial sector to grow at a fast enough rate to absorb the growing urban population has resulted in ***industrial unemployment***. Secondly, expansion of general education has created unending demand for white collar jobs which the country's urban economy has failed to meet. Thus the ranks of ***educated unemployed*** continue to swell.

Scarcity of Capital

Of all factors of economic development, capital is said to be the most important. In fact, it is the accumulation of capital that alone can help a country in its attempt to overcome its economic backwardness. Kuznets has very aptly remarked, ***"Low capital formation proportions means low rates of growth of national product, unless capital-output ratio declines, i.e., unless more output can be turned out per unit of capital."***[6] Since there is a continuous shift in favour of capital-intensive techniques in Third World countries, capital-output ratios cannot be expected to fall. Therefore, if these countries have to grow, they have no choice except to raise their rates of capital accumulation. In India both saving and investment rates have risen since Independence at a low rate. In 2001-02 the rates of gross domestic saving and gross domestic capital formation were estimated to be 23.4 and 22.6 per cent respectively. These rates of saving and capital formation are enough to realise only a modest rate of growth. This explains why in India the rate of growth remained stuck at a relatively low level. In contrast, the rates of economic growth have been remarkably high in some of the East-Asian countries. South Korea, Malaysia, Thailand, Singapore and China have excelled most countries in this respect. All these countries have one common feature, that is, the rates of saving and capital formation in all of them have been consistently over 35 per cent of GDP for long periods. ***High rates of saving and investment allow business to grow at a fast rate, introduce latest technologies and become internationally competitive. The Indian business in the past failed on these fronts largely on account of the scarcity of capital.*** However, if CSO's latest estimates are to be believed, India is fast becoming a high saving and investment economy. According to CSO's estimates saving and investment ratio were as high as 32.4 and 33.8 per cent of GDP respectively in 2005-06. This shows that there has been a spectacular increase in both saving and investment in the four year period 2001-02 to 2005-06. National accounts experts and some non-government economists however believe that CSO has overestimated saving and investment for the the last four years and thus saving and investment data for these years are to be used with caution.

Technological Backwardness

While technological progress is at the heart of development process, ***over a wide range of productive activity, techniques of production are backward in India.*** Agriculture which provides subsistence to about two-thirds of the population is even now characterized by highly backward techniques. Except in the green revolution belt of the country everywhere else farmers are persisting with centuries old outmoded production techniques. Their failure to switch over to modern techniques, however, cannot be explained in terms of their ignorance.

Modern technology is certainly scale neutral, but it is not resource neutral. Therefore, the small and marginal farmers who constitute the overwhelming majority have on account of their poverty failed to adopt new technology which in turn has kept agricultural productivity appallingly low. In the past it is this reason why the domestic market for the industrial goods has not grown rapidly enough. However, in large scale industries, energy, transport and communications sectors modern production techniques have been introduced. Nevertheless there still exists a wide gap between the sophisticated production techniques of the developed countries and our technology. Over the years India has built up substantial capability in science and technology and if this country's business harnesses this resource in a purposeful manner it can overcome one of its major obstacles to development.

Lack of Entrepreneurs

Joseph A. Schumpeter has assigned a vital role to entrepreneurs in his theory of growth. According to him, ***"the function of entrepreneurs is to reform or revolutionize the pattern of production by exploiting an***

invention or, more generally, an untried technological possibility for producing a new commodity or producing an old one in a new way by opening up a new source of supply of raw materials or a new outlet for products, by reorganising an industry and so on."[7] Obviously these activities require aptitudes that are present only in a small fraction of the population. Therefore, if some society possesses people who are gifted with entrepreneurial skill, it is bound to grow rapidly. Some economic historians contend that the presence of this class in England, Germany and the USA had a major role in their development. In contrast, such a class did not exist during the British period in India. Even after Independence for about four decades the Indian business class did not show much entrepreneurial skill as it operated under a protective umbrella. This situation has, however, changed since 1990-91 due to economic liberalisation. In India, the consistent pursuit of neo-liberal policy has created scope for the development of industries which, in turn, has led to emergence of a new class of entrepreneurs.

INDIA—A DEVELOPING ECONOMY

In our foregoing analysis we have underlined the fact that the Indian economy is still underdeveloped. But this is not an adequate description of the nature of the Indian economy. India's economy had suffered a long period of stagnation under the British. After Independence, this long spell of stagnation was broken. With the beginning of economic planning, an era of economic development was ushered in. ***Economic development in India has broadly two facets:***

(1) Quantitative

(2) Structural.

From the point of view of the business enterprises both are relevant. For assessing the development process in quantitative terms national income trends are to be examined. But still more necessary is to take note of the structural changes in the economy. The two together, in fact, broadly indicate the business prospects in the country.

National Income Trends

Immediately after Independence, India was bogged down in problems created by the partition of the country. World War II had also left certain problems such as inflation and food shortages. Moreover, the country caught in 'the low level equilibrium trap' during the British period had no easy way out to tread on a high growth path. This was a dismal situation from the point of view of the business.

Aware of its own limitations the business community in India expected effective intervention of the government in the economy. The government thus adopted economic planning in the capitalist framework. The Indian plans which were indicative in nature did transform India's stagnant economy into a developing economy. The rate of economic growth, however, remained low in the first three decades of economic planning. ***Since 1951 the net national product (NNP) increased at a modest rate of 3.4 per cent per annum.*** Increase in per capita income in this period was as low as 1.2 per cent per annum. This obviously did not provide any scope for rapid growth of business. The situation drastically changed in the 1980s. The trend rate of growth suddenly picked up and for ten years the NNP increased at the rate of 5.6 per cent per annum. In the two years 1990-91 and 1991-92 the country was caught in a deep economic crisis and as a result growth rate declined steeply. The new economic policy which was adopted in 1991, temporarily put the Indian economy on a high growth path. During the Eighth Plan period the rate of increase in the NNP was 6.7 per cent per annum. The per capita income also registered an impressive growth rate in this period as it was as high as 4.5 per cent per annum. There was a slowdown during the Ninth Plan period and in the five years of the Plan the rate of increase in the national income had come down to 5.6 per cent per annum. This was definitely not an encouraging situation. ***However, the rate of increase of national income improved considerably over the Tenth Plan period (2002-03 to 2006-07) and stood at 7.7 per cent per annum[8]. The last year of the Tenth Plan 2006-07 registered 9.9 per cent increase in national income.***

Structural Changes

Apart from the growth in quantitative terms, there have been significant changes in India's economic structure since Independence. These structural changes indicate that the process of development which began in the early 1990s is still continuing. Let us now consider whether importance of agriculture in Indian economy has declined since independence and the occupational distribution of the population has improved; and whether basic and capital goods industries have developed and infrastructure and the financial sector have grown.

Sluggish sectoral changes in the Indian economy. An important index of development is a steady

decline in the importance of agriculture and allied activities in the economy in terms of their contribution to gross domestic product. The importance of agriculture and allied activities in the Indian economy has somewhat declined since Independence. In 2006-07 the share of agriculture and allied activities in the gross domestic product (GDP) was 18.5 per cent as against 37.9 per cent in 1980-81 and 44.2 per cent in 1970-71. The share of the output in the secondary sector comprising industries, construction, electricity, etc. rose in the GDP from 15.4 per cent in 1970-71 to 17.4 per cent in 1980-81 and 19.6 per cent in 2006-07. Tertiary sector is not a homogenous category. This includes trade, transport, communications and services. During the past three and a half decades the share of this sector in the GDP rose from 40.1 per cent in 1970-71 to 61.8 per cent in 2006-07 (at 1999-2000 prices).[9] These facts clearly indicate significant changes in the structure of the economy. ***The Indian economy is no longer a subsistence agrarian economy. Now its structure provides beyond any doubt a far more congenial environment for business activities as compared to about two decades ago.***

The occupational distribution of population in India, however, raises some doubts about the validity of these observations. In a developing economy, occupational distribution of population steadily changes in favour of secondary and tertiary sectors. This happens as a result of decline in the importance of agriculture from which transfer of population to other sectors takes place. In India, now data from the Census of 2001on occupational distribution of the workforce are available. We thus consider occupational distribution of workforce in 2001 and compare it with that in 1951 to see if there was any change in the position. We find that ***in India, agriculture accounted for 64.8 per cent of the workforce in 2001 as against 69.7 per cent in 1951. This implies that the occupational distribution of workforce had not changed significantly during the 50 years period from 1951 to 2001 though the economy had recorded a not too insignificant growth.***

Growth of basic capital goods industries. At the time of Independence, not only India's industrial structure was underdeveloped in a general way, its backwardness was more clearly manifested in the absence of basic capital goods industries. Since Independence, pattern of industrialisation has been determined by the policies of the State. Under the Second Plan, a high priority was accorded to capital goods industries, as their development was considered a prerequisite to overall growth of the economy. This strategy of development was at the heart of India's economic planning for about two and a half decades—beginning from 1956. Consequently, ***a large number of basic industries which produce capital equipment and useful raw materials have been set up making the country's industrial structure pretty strong. These industries now account for more than fifty per cent of the industrial production.***

Development of infrastructure. Infrastructure includes transport facilities, energy production, and telecommunication system. Their development creates favourable conditions for business growth and also for better human living. Therefore, when these facilities expand in some country, it can be assumed that the country is undergoing a change for the better. *The World Development Report 1994* aptly remarked, ***"Infrastructure represents, if not the engine, then the 'wheels' of economic activity."***[10]

In India, though presently infrastructure is a major constraint on business growth, at the same time the fact remains that over the years it has registered an impressive growth. The transport system over the past four decades has grown both in terms of capacity and modernisation. The railways' route length increased by more than 9,000 kms and the operation fleet has practically doubled. Further, steam locomotives have been replaced by diesel and electric locomotives improving the efficiency of railways. The Indian road network is now one of the largest in the world as a result of spectacular development of roads under various plans. The total road length comprising National highways, State highways and other roads was 32.2 lakh kms in 2005-06 as against 14.9 lakh kms in 1980-81. Progress of shipping and civil aviation has been equally impressive. Though the country is presently facing an energy crisis creating an impression that much development has not taken place in this sector, the fact, however, is that over the past two decades there has been a massive increase in installed electricity generating capacity in the country. In 2005-06 installed electricity generating capacity was 1,43,800 M.W. against 33,400 M.W. in 1980-81.

After the announcement of new telecom policy in India, there has been a spectacular progress in telecom in India. Nevertheless India with tele-density of 6.9 in December 2003 lags far behind China and Brazil where tele-density is more than 42. However, in recent future Indian telecom is well set for high growth.

Progress in the banking and financial sector. Since Independence significant progressive changes have taken place in the banking and financial structure of India. In this period, organisation of money and capital markets has improved, specialised industrial financing institutions were set up, banking services have increased and modern banks have reached small towns and villages. The growth of commercial banks and cooperative credit societies has been really spectacular.

During the British period, the whole banking development had taken place in the private sector. The process of nationalisation was initiated after Independence. First, the Reserve Bank was nationalised in 1949. Thereafter in 1955 the Imperial Bank of India, a leading commercial bank of the time, was nationalised and converted into the State Bank of India. In 1969, fourteen big commercial banks were nationalised. This act of the government undermined the control of big capitalists on the finance capital. ***Since nationalisation, these banks radically changed their credit policy, and as a result more funds were made available to priority sectors such as agriculture, small-scale industries, transportation etc.*** However, the directed credit and directed investment programmes together with mounting expenditures eroded the profitability of the banks. ***The government thus introduced comprehensive financial sector reforms.*** For banks, new income recognition and provisioning norms and accounting procedures and formats have been laid down. Regarding capital market, the policy of liberalisation is being pursued without abandoning all regulations. Since regulation along with liberalisation helps in capital market development, the government set up a regulatory body, the Securities and Exchange Board of India (SEBI) in 1988. The SEBI was given statutory powers in 1992. In brief, the financial markets and institutions are now more viable and efficient and can thus serve business better.

To sum up, ***the Indian economy, though economically still backward, is no longer caught in a 'low level equilibrium trap' where it remained for a long period under the British rule. Since Independence it has recorded a not too insignificant increase in the national income and per capita income, though one cannot be equally sure of the trickle down effects of growth. We further notice that the Indian economy during the past five and a half decades has progressed structurally*** when we consider the growth of capital goods industries, expansion of the infrastructure, performance of the public sector, changes in the financial organisation and the progressive transformation of the agrarian scene. These factors over the years are believed to have created an element of dynamism in the country's economy and one can now hopefully say that it would sustain development in the future.

INDIA—A MIXED ECONOMY

The Indian economy is a mixed economy. It acquired this form with the adoption of economic planning and growth of a large public sector since Independence. In India, the Second Five Year Plan summed up the objectives of planned economic development in the phrase "socialist pattern of society" implying that "the basic criterion for determining lines of advance must not be private profit, but social gain..."[11] and yet the character of the economy that has emerged as a result of planned development does not resemble even remotely socialism. Nationalisation of banks, setting up a number of enterprises in the public sector and such other measures may create an illusion that the economy has advanced towards socialism but in fact socio-economic relations have not undergone any such change as to warrant the conclusion that the Indian economy has drifted away from its capitalist form.

The main features of India's economy that determine its character as a mixed economy are as follows :

1. Private ownership of the means of production. Under Indian Constitution private ownership of the means of production has been allowed. It is this reason why the private sector in this country remains pervasive. ***The share of the public sector in the total national output is less than 25 per cent.***

2. Predominance of the market. ***Market holds a predominant position in the Indian economy.*** At present this country has markets for commodities as well as productive factors. In these markets prices are determined by the interplay of demand and supply forces. Business firms guided by the product prices usually decide as to what commodities they will produce. Even the choice of inputs depends on their prices. ***However, the market mechanism in India has not been completely free from the State control.*** In 1951, Industries (Development and Regulation) Act was passed to provide a regulatory system for industrial activity in the country. Apart from the licensing system, the government also introduced certain other controls and incentive measures for influencing the decisions in the markets. Among these, most notable were import controls, distribution of essential goods at fair price shops and government purchase of agricultural products at support prices. These controls and incentive measures, however, do not alter the basic character of market mechanism. Their importance lies only in their capacity to undermine the irrationality of certain market decisions by changing them for the better.

3. Growth of private sector monopolies. ***Since Independence, monopoly houses have grown rapidly and with it the concentration of economic power in the country has increased.*** This trend was first noted by the Committee on Distribution of Income and Levels of Living chaired by P.C. Mahalanobis, Since then,

monopoly trends appear to have become stronger and the grip of big business on the economy seems to have increased, in spite of the governmental measures to control them. Each of the four largest private sector enterprises in 2006 possessed assets worth Rs. 19,420 crore or more and assets of Reliance Industries were as large as Rs. 96,871.52 crore.

4. Public sector. ***In India, a large public sector co-exists with the private sector and this fact alone is enough to determine the character of the economy as mixed.*** The creation of a large public sector by the government in this country has not been inspired by any ideological considerations. At the time of Independence the private enterprise lacking both resources and will to make heavy investments had expected from the government to develop infrastructure and basic capital goods industries. The government's intervention in the form of expansion of public sector was thus a historical necessity and it did not aim at altering the character of the economy.

5. Economic planning. ***Economic planning has been an integral part of the Indian economy since 1951.*** The nature of economic planning in India has always been different from the one adopted in former Soviet Union and other East European countries. This country adopted planning while retaining its capitalistic structure, whereas former Soviet Union and other East European countries had transformed their economies into socialist economies and the planning was an important instrument in this exercise.

The Indian experience shows that the mixed economy framework is a feasible proposition for a developing country as it allows for a modest rate of growth, which is both steady and less subject to fluctuations in the economic activity at the international level. This requires over time substantial growth of productive capacity in the key sectors of the economy. In the mixed economy framework this can be ensured by transferring commanding heights of the economy into the hands of the State. Such a system is also consistent with an increase in the rates of saving and capital formation. India's experience over the years proves this point. In may thus be argued that the mixed economy framework which India decided to pursue after getting Independence enabled it to overcome one of the major obstacles to its economic growth. As stated earlier, the pursuit of a mixed economy framework does not transform a capitalist economy into a socialist economy. Sukhmoy Chakravarty rightly states that India's experiences shows that ***"adherence to a mixed economy does not imply that it will grow into what many people once thought to be its rationale, i.e., a socialist pattern of society. In fact, a mixed economy is an unstable blend of different features, which is dynamically compatible with different outcomes. Which outcome finally prevails depends on a changing balance of social forces and also on the ability of the political processes to find corridors of action."***[12]

MACROECONOMIC SCENARIO

For the revival of business activity in this country there has to be a definite improvement in the macroeconomic scenario. But will it really happen in near future cannot be said at this juncture though neo-liberal economists are euphoric about short-term non-inclusive growth. In order to understand the macroeconomic scenario of the Indian economy one must take note of the following facts :

- The modest GDP growth rate since 1997-98.
- Since 1996-97 industrial growth has been erratic.
- Increases reported by the CSO in savings and investment rates are being disputed.
- Inflation in this country remains contained for the time being.
- The fiscal deficit persists at an unsustainable level.
- Financial markets are presently in doldrums.
- Balance of payments situation remains satisfactory.

Economic Growth Since 1997-98

The CSO has now released a new series with 1999-2000 as base for the entire period of planning. According to this series, GDP rose at the rate 6.6 per cent per annum over the Eighth Plan Period (1992-97). However, this rate of growth fell to only 5.5 per cent per annum during the Ninth Plan (1997-2002). This slipped to 3.8 per cent in 2002-03 largerly because of setback to the agricultural sector. In fact, the agricultural sector had grown at an annual rate of 3.5 per cent during the early 1990s. This naturally supported industrial growth. However, ***since 1995-96 agricultural growth has been both slow and erratic. It was a mere 0.2 per cent in 1995-96 and shockingly negative in 1997-98. 2000-2001 and 2002-03.*** In terms of composition, despite good monsoons, the average growth of agricultural production for the 1990s (1992-2001) was 2.5 per cent compared to 3.5 per cent in the 1980s (1981-90). A mere 1.2 per cent per annum increase in foodgrains

output® during 1990s led to an annual increase of 5.0 per cent in foodgrains prices since 1995-96. In an agrarian economy when prices of foodgrains increase rapidly, demand for manufactured goods fails to expand at a rate that would make industrial growth buoyant. During the latter half of the 1990s this was precisely India's experience. However, as stated earlier, economic growth picked up during the Tenth Plan period (2002-07) and the rate of increase in national income in this plan was as high as 7.7 per cent per annum.

Erratic Industrial Growth

Since 1996-97 industrial growth in this country has been erratic. The rate of industrial growth had collapsed to 5.6 per cent in 1996-97 from 12.2 per cent in 1995-96. It was 6.7 per cent in 1999-2000 but registered a further decline to 5.0 per cent in 2000-01 and to 2.7 per cent in 2001-02. There was some recovery in 2002-03. However, industrial growth remained modest at 5.8 per cent. In 2002-03, the industrial production increased by 7.0 per cent. Since 2004-05 the rate of industrial growth has been rising and it is now over 8.6 per cent per annum. ***During the Tenth Plan period as a whole it has been 8.9 per cent per annum which is less than the target of 10 per cent per annum laid down in the Plan.*** This is without doubt a mixed picture of the industrial sector. It seems that a deceleration in exports, reduction in consumer demand due to growing income inequalities and low growth of rural incomes, slow down in industrial investment and infrastructural bottlenecks contributed most to the erratic nature of industrial growth. The last few years have witnessed a sharp fall in exports of manufactured goods due to both domestic and external factors. An overvalued exchange rate and infrastructural bottlenecks made India's exports non-competitive. Further, steep fall in demand for Indian goods from Russia and East European countries and global recession caused major setback to our exports. In this difficult situation, the relatively cheaper imports put competitive pressure on several industries like steel, electronics and chemicals forcing them to cut-down their production.

Since 1996-97 there has been a significant decline in industrial investment. This steep fall in industrial investment led to a decline in the rate of industrial growth. Not only this caused a slow down in capacity expansion which constrained increase in industrial production, but it also adversely affected the demand for manufactures due to low income generation in the industrial sector.

Community, social and personal services sector includes government administration and defence community social, and personal services. Services sector as a whole registered 7.4 per cent growth in 2002-03 while overall GDP growth was as low as 4.0 per cent. However, the largest contribution to GDP growth during the last few years has come from the service sector taken as a whole. Obviously, growth in the services sector does not add to the material output of the economy and thus weakens the fundamentals of the economy. Likewise, the growth of income of financial services, most importantly the higher income arising from interest rate increases and the increase in trading income arising from profiteering in period of temporary shortages do not improve the fundamentals of the economy. Shankar Acharya has rightly argued, ***"Services are hugely important, but they cannot, by themselves, assure rapid and sustained growth of the Indian Economy."***[13]

Savings and Investment Growth in Recent Years

The gross domestic savings rate failed to increase during the 1990s. It was 22.8 per cent in 1990-91. Thereafter for three years it continued to decline and in 1993-94 was at a level lower than that reached in 1978-79. The recovery started in 1994-95 and for two years the gross domestic savings rate fluctuated around 25.0 per cent. Thereafter it declined again and was 23.4 per cent in 2001-02. However, it is quite strange that since 2002-03 it registered a spectacular increase. According to CSO's estimates, the gross domestic savings rate was as high as 29.7 per cent in 2003-04 and this rose further to 32.4 per cent in 2005-06. Validity of these estimates has been doubted[14].

Gross domestic capital formation has been generally higher than gross domestic savings by 1-2 per cent of GDP. Foreign capital inflows bridged this investment-savings gap. Domestic capital formation which was estimated to be 24.6 per cent of GDP in 1997-98 declined to 22.9 per cent of GDP in 2001-02. This level is around 3.0 per cent lower than the average for 1994-95 to 1996-97 which was definitely a substantial step up from the level of the early 1990s. CSO's estimates for 2002-03 and subsequent years indicate spectacular increase in gross domestic capital formation. It is clear that the CSO obtained 26.6 per cent rate of investment for 2003-04 by making adjustment for errors and omissions amounting to 3.3 per cent of GDP. K. N. Raj Working Group on Savings (1982) had pointed out that ***'errors and omissions' in estimation of investment represent only the discrepancies and thus no adjustment be made to the independently estimated gross domestic capital formation.*** If this method is followed, the investment rate for 2003-04 comes out to be only

around 23 per cent. However, the CSO continues to make adjustment for 'errors and omissions'. This has pushed up the rate of gross domestic capital formation to 33.6 per cent for the year 2005-06.

Prices and Inflation

Inflation is conventionally estimated in terms of movement of wholesale prices. However, from the point of view of the consumers, retail prices are far more relevant and thus inflation is to be measured in terms of consumer price index. In India, presently, apart from Wholesale Price Index (WPI), three different indices of consumer prices are available. These are Consumer Price Index for Industrial Workers (CPI-IW), Consumer Price Index for Urban Non-Manual Employees (CEP-UNME) and Consumer Price Index for Agricultural Labourers (CPI-AL). Inflation rate is at present moderate if considered in terms of wholesale prices movement. Inflation rate based on Wholesale Price Index was 4.5 per cent on April 3, 2004. Thereafter it accelerated to a peak of 8.7 per cent on August 28, 2004, but it began decelerating since September 2004. ***Inflation rate stood at 5.05 per cent on March 26, 2005 which was only moderately higher than 4.64 per cent recorded a year ago.***

During the post-reforms period, inflation had shown a distinct decelerating trend. Average Annual Wholesale Price Index inflation decelerated from 10.6 per cent per annum in the first half of 1990s to 4.7 per cent during 2000-01 to 2005-06.

It is generally argued that as compared to Wholesale Price Index, Consumer Price Index for Industrial Workers CPI (IW) is a more appropriate index to determine the impact of price rise on the cost of living of the common man. The CPI (IW) is measured on the basis of retail prices and is used to determine the dearness allowance of employees in both the public and private sectors. In sharp contrast to WPI, CPI (IW) inflation has been stable and moderate in recent years, because of moderate increases in prices of food items which have higher weights in CPI (IW) than in WPI.

Annual point to point CPI(IW) inflation declined from 5.1 per cent per annum in April 2003 to 2.2 per cent in April 2004. CPI (IW) inflation rate began rising in April 2004 and reached 6.3 per cent per annum in December 2006. Moreover, food group inflation has been lower in CPI (IW) than in WPI implying that prices of food articles rose slower in the wholesale markets than in retail markets.

Fiscal Imbalance

Fiscal imbalance has persisted over the years in the form of large government deficits. Although concepts of revenue deficit and primary deficit are very much relevant to understand the malaise in the government finance, lately main attention is being given to fiscal deficit. This approach is not entirely correct and therefore in our discussion we shall refer to estimates of other deficits as well. ***The gross fiscal deficit refers to the difference between the revenue receipts (net) plus non-debt capital receipts and the total expenditure including loans net of repayments.*** Non-debt capital receipts arise from the sale of assets. In the present case, such receipts arise from the sale of government equity in public sector enterprises. According to Arun Ghosh *et al.*, "This is not only odd, it is accounting fudge, and by taking a capital receipt into the revenue account as a normal receipt, we are violating all canons of accounting honesty."[15] This criticism of the concept of gross fiscal deficit is valid. Nonetheless with all its limitations, estimates of gross fiscal deficit in India reveal the quantum of fiscal imbalance. ***Combined gross fiscal deficit of both Centre and States was 9.4 per cent of GDP in 1990-91. This was certainly unsustainable and thus should have been brought down. Reduction in fiscal deficit to a sustainable level actually formed a significant component of the economic reforms initiated in 1991.*** However, there has not been much success in lowering down the fiscal deficit. ***The gross fiscal deficit of the Central and the State Governments together remained 8.5 per cent of GDP in 2003-04 and 7.5 per cent in 2004-05 (however, it fell to 6.4 per cent in 2006-07).***

It is a matter of grave concern that revenue deficit had risen in 1998-99 to 6.4 per cent of GDP from 4.1 per cent in 1997-98 ***(Revenue deficit refers to excess of current expenditure over current revenue).*** Revenue deficit was 4.2 per cent of GDP in 1990-91. Having declined to 3.2 percent in 1995-96 there was a turnaround in revenue deficit in 1996-97. Since then it continued to rise to upto 7.0 per cent in 2001-02. However, in two years that followed there was a modest decline in revenue deficit. ***Revenue deficit nonetheless remained as high as 5.8 per cent of GDP in 2003-04. It was, however, brought down to 2.7 per cent in 2005-06 and further to 2.1 per cent in 2006-07 due to Central government's obligations under FRBM Act.***

Primary deficit is computed by deducting interest payments from fiscal deficit. It thus reflects the borrowings of the government to meet expenditures other than interest payments. The primary deficit of the

Central and the State governments taken together was 5.0 per cent of GDP in 1990-91 and 2.1 per cent of GDP in 2003-04. In 2006-07, it was reduced to just 0.8 per cent of GDP.

To tackle the problem of fiscal imbalance in coming years, on the one hand, the government will have to improve revenue collections and on the other hand, contract expenditure. In India, there is a belief in official circles that large classes of people in this country are too poor to pay taxes. Therefore, tax base has become too narrow. At present the Indian tax-GDP ratio (about 15.0 per cent) is one of the lowest in the world. The average ratio is about 31 per cent for industrial economies and 18 per cent for developing countries. According to Ashima Goyal, "Because a large part of the economy is in the unorganised sector where returns are not routinely filed, it is believed that Indian GDP is 60 to a 100 per cent under-estimated. In that case the tax-GDP ratio will be even smaller."[16]

The government expenditure is also responsible for the existing fiscal malasie. At present, interest payments are large as they are around 3.7 per cent of GDP. Attempts to reduce the burden of interest payments have not been successful during the post-economic reform period.

Subsidies, both explicit and hidden, constitute the second head of public expenditure which has contributed to existing fiscal mess. In 1997, D.K. Srivastava, Tapas Sen and others had estimated both explicit and hidden subsidies provided by the Central and the State governments. Their study revealed that the total subsidies by the Central and the State governments were as large as 14.4 per cent of GDP.[17]

Monetary and Capital Market Developments

The year-on-year broad money (M_3) growth was 17.0 per cent in 2005-06 against 12.3 per cent in 2004-05. Reserve money registered a growth of 17.2 per cent in 2005-06 compared with 12.1 per cent growth in 2004-05. All these facts indicate that monetary expansion in 2005-06 was larger as compared to 2004-05. The rate of GDP growth being somewhat higher in 2005-06 as compared with growth rate in the previous year, the inflation rate measured in terms of wholesale prices remained rather subdued due to recessionary conditions, particularly inadequate aggregate demand.

Investments by scheduled commercial banks in government and other approved securities have remained much above the stipulated statutory liquidity ratio (SLR) of net demand and time liabilities (NDTL) in recent years. The capital market has also shown considerable buoyancy. This would be clear from the fact that resource moblisation through the primary market has risen from Rs. 69,543 crore in 2003 to as high as Rs. 1,61,769 crore in 2006.

In this context several points are relevant. First, since there has been a steep rise in new issues, public investment did not 'crowd out' private investment; in fact, there was 'crowding in' effect of public investments. Secondly, the government has over the years developed obsessions with daily fluctuations in the Bombay Sensex. This encouraged the spirit of speculation and the lure of quick capital gains. A bullish run in the Bombay Stock Exchange often does not mean a recovery in the industrial sector; it in most cases reflects the speculative machinations of resourceful speculators.

There was a rebound in primary market issues, particularly in intial public offerings (IPOs) of equities in the securities markets in 2006. The volume of equity rose to a level of Rs. 32,672 crore in 2006. The bulk of this was made up of IPOs which amounted to Rs. 24,779 crore in 2006. This was two and a half times the amount realised by IPOs in the previous calender year 2005. The private placement has remained upbeat since 2003 and was as huge as Rs. 1,17,407 crore in 2006. These facts are considered to be indicators of industrial recovery in this country.

External Sector

These are two important issues to be analysed in the external sector :

(i) External trade position,

(ii) Foreign capital flows

External trade position. India's external trade position looked satisfactory in the first half of the 1990s. In fact, in the mid 1990s for three years when exports registered an impressive growth (in the range of around 20 per cent per annum) several policy makers argued that the strategy of export led growth was going to put this country in the company of Asian Tigers. However, all this changed during the three years since the middle of 1996. The export trends for India were rather disappointing. Imports in this period had been restrained because of the domestic industrial recession. Nonetheless, the trade balance had worsened and the trade deficit

amounting to $ 9,171 million in 1998-99 was extremely worrisome. There was a sense of urgency on the trade front due to 5.1 per cent decline in exports in dollar terms in 1998-99. The causes of the export decline were not clearly established. The official policy makers attributed most of the decline in exports in 1998-99 to external factors such as the general lack of recovery in the world trade after 1996, the economic slowdown in developed countries, especially Japan and Germany and the dramatic depreciation of the currencies of several East Asian countries.

However, exports have shown considerable growth during the Tenth Plan period. From $ 52,719 million in 2002-03 (the first year of the Tenth Plan) exports have risen to $ 1,26,331 million in 2006-07 (the last year of the Tenth Plan). The average rate of growth of exports during this Plan has been 24 per cent as against the target of 12.38 per cent. According to *Economic survey* 2006-07, both external and domestic factors have contributed to this satisfactory performance. Improved global growth and recovery in world trade aided the strengthening of Indian exports. As far as domestic factors are concerned, the opening up of the economy and corporate restructuring has enhanced the competitiveness of Indian industry. There has been substantial increase in earnings from invisibles in recent years. This has enabled the country to register surplus in current account in three years in a row 2001-02, 2002-03 and 2003-04. The net capital inflows have also increased considerably. As a result, there has been a large build-up of foreign exchange reserves. However, the increased dependence upon relatively hot money flows such as portfolio investment and short term credits has become a cause of concern because reversals can suddenly occur. ***The government thus maintains a very high level of foreign exchange reserves.*** They touched $ 240 billion in September 2007. However, the experience of other countries suggests that even such a high level of reserves may not be adequate to ward off crises in the face of determined speculative pressure.

Foreign capital flows. Prior to the 1990s the government relied completely on foreign borrowing to bridge investment-savings gap. Foreign direct investment (FDI) which was virtually non-existent until 1990-91. rose during the post-reform period at a considerable pace. This would be clear from the fact that FDI which was merely $ 129 million in 1991-92 rose to $ 7,751 million in 2005-06 and further to the high figure of $ 19,513 million in 2006-07. According to Reserve Bank, the sudden spurt in 2006-07 has been due to expansion in domestic activity, positive investment climate, progressive liberalisation of the FDI regime, and simplification of procedures. The rising pace of mergers and acquisitions in sectors such as financial services, manufacturing, banking services, information technology and construction also boosted FDI inflows.[18] Among the developing countries, India has now emerged as the second most preferred FDI destination after China. India's share in global FDI inflows increased from 2.3 per cent in 2005 to 4.5 per cent in 2006.

In addition to FDI, considerable portfolio investment has also taken place during the post-reform period. From just $ 4 million in 1991-92, portfolio investment rose to $ 12,492 million in 2005-06 which, however, fell to $ 7,003 million in 2006-07. The main reason for rising portfolio investment has been the sharp increase in FII (foreign institutional investment) which was negligible in 1991-92 but picked up to $ 1,665 million in 1993-94 and to the high level of $ 10,918 million in 2003-04 (in subsequent period it has declined and stood at $ 9,926 million in 2005-06 and $ 3,225 million in 2006-07). According to the Reserve Bank, the rapid rise in FII in the post-reform period reflects the investors' confidence in the Indian economy.

As a result of rising FDI and portfolio investment in the post-reform period, total foreign investment inflows have registered an impressive increase (from $133 million in 1991-92 to $ 20,214 million in 2005-06 and further to $ 26,534 million in 2006-07). This has generated a lot of euphoria in the official circles and it is being said that "strong fundamentals" of the economy aided by liberalised goverment policy has led to the boom in foreign investment inflows. However, critics have pointed out that foreign investment inflows (particularly by FIIs) carry the risk of sudden reversal. This is due to the reason that FII inflows are highly volatile in nature as they are driven by short-term expectations, characterised by 'herd behaviour'. Particularly risky is the dependence on PN (participatory notes) as they are convenient avenues through which speculative flows can occur.[19]

NOTES

1. World Bank, *World Development Report, 2005* (New York, 2004), Table 2, pp. 258-9.
2. Government of India, Planning Commission, *Sixth Five Year Plan, 1980-85,* (New Delhi), p. 52.
3. Government of India, Planning Commission, *Ninth Five Year Plan,* Volume I (Delhi, 1999), Table 1-9, p. 27.
4. The National Sample Survey Organisation, 54th Round.
5. Robert Cassen, "Development and Population", *Economic and Political Weekly,* Special Number 1976, p. 1181.

6. Simon Kuznets, *Six Lectures on Economic Growth* (Glencoe, 1959), p. 70.
7. Joseph A. Schumpeter, *Capitalism, Socialism and Democracy* (New Delhi, S. Chand and Co. 1980), p. 132.
8. Data pertain to NNP at factor cost at constent (1999-2000) prices. Average rate of growth has been calculated from Reserve bank of India, *Handbook of Statistics on Indian Economy, 2006-07,* (Mumbai, 2007), Table 235, p.604.
9. Calculated from Reserve Bank of India, *Handbook of Statistics on Indian Economy,* 2006-07 (Mumbai, 2007), Tables 2 and 3.
10. World Bank, *World Development Report 1994* (New York: Oxford University Press, 1994), p. 14.
11. Government of India, Planning Commission, *The Second Five Year Plan* (Delhi, 1956), p. 22.
12. S. Chakravarty, *"Policy Making in Mixed Economy :The Indian Case," in P. R. Brahmananda and V.R. Panchmukhi (ed.), The Development Process of the Indian Economy* (Mumbai: Himalaya Publishing House, (1987), p. 731.
13. Shankar Acharya, "Services Not the Real Saviour" *Economic Times,* September 5, 2002.
14. S. L. Shetty, "Saving and Investment Estimates — Time to Take a Fresh Look" *Economic and Political Weekly,* Ferbruary 12, 2005, pp. 606 - 10.
15. Arun Ghosh, C.P. Chandrashekar and Jayati Ghosh,"The Macroeconomic Scenario" in *The Indian Economy 1997-98 — An Alternative Survey* (New Delhi, 1998) p. 17.
16. Ashima Goyal, "Political Economy of the Revenue Deficit", in Kirit Parikh (ed.) *India Development Report 1999-2000* (New Delhi, 1999), p. 140.
17. D.K. Srivastava, Tapas Sen and others, *Government Subsidies in India,* (New Delhi, National Institute of Public Finance and Policy, 1997).
18. Reserve Bank of India, *Annual Report, 2006-07* (Mumbai, 2007), pp. 93-94.
19. In this context please see Chapter 43 on 'Foreign Investment, Technology and Multinational Corporations' particularly Box 43.1 on participatory notes.

CHAPTER

18 ECONOMIC REFORMS AND LIBERALISATION

The Origin of Economic Crisis
• The Fiscal Imbalance–Crisis of 1980s • Fragile Balance of Payments Situation during the 1980s
Economic Reforms
Macroeconomic Stabilisation
• Fiscal Adjustment • Balance of Payment Adjustment
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An Appraisal of Economic Reforms
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THE ORIGIN OF ECONOMIC CRISIS

In early 1991, a major economic crisis surfaced in India. This crisis in the economy was the worst that the country had experienced since Independence. The origins of the crisis can be traced to the cavalier macro management of the economy during the 1980s which led to large and persistent macro-economic imbalances. The widening gap between the revenue and expenditure of the government resulted in ***unsustainable fiscal deficits*** which had to be met by borrowing at home. Further, the steadily growing difference between the income and expenditure of the economy as a whole resulted in ***large current account deficits in the balance of payments*** which were financed by borrowing from abroad. According to Deepak Nayyar, ***"The internal imbalance in the fiscal situation and the external imbalance in the payments situation were closely related, through the absence of prudence in the macro management of the economy."***[1] This was, however, not appreciated particularly during the 1980s and in an attempt to live beyond means, the economy was pushed into a deep economic crisis.

The Gulf crisis in late 1990 sharply accentuated macro-economic problems and a macro-economic crisis erupted in the form of :

1. Unsustainable fiscal deficit, and
2. Unsustainable current account deficit in balance of payments.

The Fiscal Imbalance — Crisis of the 1980s

The fiscal crisis of the 1980s was not a coincidence. The fiscal situation had deteriorated throughout the 1980s due to growing burden of non-development expenditures. All the indicators of fiscal imbalance reflect that throughout the eighties it was on the rise. ***The indicators which are normally used to measure fiscal imbalance are the budgetary deficit, the revenue deficit, and the gross fiscal deficit.*** Of these, first two known as conventional measures of fiscal imbalance indicate only a part of the resources gap which is mainly financed

by the issue of treasury bills. A large portion of the gap in the resources of the government is financed by market borrowings, small savings, provident funds, external borrowings etc. and this does not get reflected in the conventional measures of fiscal imbalance. ***In contrast, the concept of gross fiscal deficit is a complete measure of fiscal imbalance. It equals the excess of total government expenditure over government revenue and grants.***

In 1990-91 all the measures of fiscal imbalance indicated that there was a serious fiscal crisis. The budgetary deficit was 2.1 per cent of GDP in 1990-91 as against 0.9 per cent in 1981-82. Similarly the revenue deficit had risen from 0.2 per cent of GDP in 1981-82 to 3.3 per cent in 1990-91. However, the most disquieting development was a steep rise in the gross fiscal deficit. From 4.1 per cent of GDP in 1975-76, it rose to 6.6 per cent in 1990-91. Since this fiscal deficit had to be met by recourse to borrowings, ***the internal debt of the government increased rapidly, rising from 35 per cent of GDP at the end of 1980-81 to 49.8 per cent of GDP at the end of 1990-91.*** This naturally made burden of servicing the debt onerous.

Interest payments which were 2 per cent of GDP and 10 per cent of total Central government expenditure in 1980-81, rose to 3.8 per cent of GDP and 22 per cent of total Central government expenditure in 1990-91. How alarming this fiscal situation was can be realised from the fact that in 1990-91 interest payments had eaten up 39.1 per cent of the total revenue collections of the Central government. This obviously was an unsustainable situation. The government thus could not persist with its cavalier policy of growing reliance on borrowings to meet steadily increasing fiscal deficit to which unchecked growth of non-plan revenue expenditure was the major contributing factor.

Fragile Balance of Payments Situation during the 1980s

The balance of payments situation was highly precarious in 1991, but this was not unexpected. ***The current account deficit which was $ 2.1 billion or 1.35 per cent of GDP in 1980-81 had risen to $ 9.7 billion or 3.69 per cent of GDP in 1990-91. These continuously growing deficits had to be financed by borrowing from abroad and as a consequence India's external debt rose from 12 per cent of GDP at the end of 1980-81 to 23 per cent of GDP at the end of 1990-91. This steadily growing external debt led to an increase in debt service burden from 10 per cent of current account receipts and 15 per cent of export earnings in 1980-81 to 22 per cent of current account receipts and 30 per cent of export earnings in 1990-91.*** These mounting strains during the 1980s stretched to the breaking point in 1991 due to the Gulf crisis.

The balance of payments position was on the brink of disaster as in mid-January 1991 and again in late June 1991 the level of foreign exchange reserves dropped to levels which were not sufficient to finance imports of even ten days.

No doubt this was a very difficult situation from India's point of view, as a default in terms of financing imports and meeting debt service obligations looked imminent. The country's balance of payments position was extremely vulnerable on account of two factors which were greatly influenced by perceptions and expectations. First, it was exceedingly difficult to prevent flight of short-term debt on account of adverse international perception of the situation. Second, the net outflow of non-resident deposits which added up to $ 1.64 billion in the period October 1990-September 1991 could further increase if the perceptions had worsened. In this extremely precarious situation, default could be averted only by recourse to last-resort measures, such as using stocks of gold to obtain foreign exchange, seeking emergency bilateral assistance from donor countries and borrowing under special facilities from the IMF. Thus soft options which the government adopted during the 1980s had such repercussions that in 1991-92, it was left with no options but to resort to measures which, although helping the country to avert default in meeting payments obligations, pushed it into a recessionary situation.

ECONOMIC REFORMS

In response to the crisis situation of 1990-91 the government decided to introduce economic policy reforms which consisted of two distinct strands—

1. Macroeconomic Stabilisation
2. Structural Reforms.

While stabilisation deals with demand management, structural reforms deal with sectoral adjustments designed to tackle the problems on the supply side of the economy.

BOX 18.1. Economic Reforms

Macroeconomic Crisis of the Early 1990s—Two Aspects
- Fiscal Imbalance — Crisis of the 1980s
- Fragile Balance of Payments Situation during the 1980s

The Crisis Made Economic Reforms Necessary

Two Distinct Strands of Reforms

I. Macroeconomic Stabilisation—Demand Management
- Fiscal Adjustment leading to Sustainable Fiscal Position
- Balance of Payments Adjustment

II. Structural Reforms—Supply-side Management
- Trade and Capital Flows Reforms
- Industrial Deregulation
- Disinvestment and Public Enterprise Reforms
- Financial Sector Reforms

MACROECONOMIC STABILISATION

Macroeconomic stabilisation (often called just stabilisation) involves returning to sustainable fiscal and balance of payments position. Stabilisation is necessary to overcome a crisis but it assumes a special importance if structural reforms are also introduced together with stabilisation. This is because structural reforms often add to macroeconomic pressures. For example, in the short run, trade liberalisation may increase deficits in the balance of payments and financial sector reforms may worsen fiscal position by raising the cost of public borrowing. Therefore, stabilisation must accompany structural reforms and stabilisation policies have to be bold and effective, otherwise extra macroeconomic strains generated in the reform process can disrupt the latter completely. Vijai Joshi and I.M.D. Little have argued, ***"In the longer run, structural reform is as helpful for stabilisation as stabilisation is for structural reform. In the absence of reform, losses of public enterprises would continue to burden the budget; trade restrictions would hamper the growth of exports; and compulsory government capture of private savings would erode fiscal discipline."***[2]

The Congress government which assumed office at the end of June 1991 responded quickly to the economic crisis. Besides committing itself to a comprehensive programme of structural reform, it accorded an overriding priority to the stabilisation of the economy. To this end, a policy to accomplish the following was adopted :

1. Fiscal correction
2. Improving the balance of payments position

Fiscal Adjustment

Fiscal adjustment is necessary for dealing with the twin problems of high domestic inflation and large deficits in the balance of payments. Fiscal deficit of the government (Centre, State and Union Territories together) was less than 6 per cent of GDP at the beginning of the 1970s. It, however, rose to about 7.5 per cent of GDP by the beginning of the 1980s and was as large as 9.4 per cent of GDP in 1990-91. The factor which contributed most to the growing fiscal deficit was sharp deterioration of the balance on revenue account. In 1970-71, the government had a revenue surplus of about 0.3 per cent of GDP, but the situation drastically changed during the 1980s, as by 1985-86 there was a revenue deficit of about 2.1 per cent of GDP which rose to 4.2 per cent in 1990-91. The government having recognised that such high levels of fiscal deficits, both overall and on revenue account, were not sustainable, committed itself to a policy of fiscal adjustment.

The Central government initiated a programme of fiscal adjustment under which its fiscal deficit which was around 7.85 per cent of GDP in 1990-91, was reduced to 5.56 per cent in 1991-92 and further to 5.37 per cent in 1992-93. The Central government also announced its fiscal adjustment programme for the medium term according to which its fiscal deficit was expected to be brought down to about 3 to 4 per cent by the mid-1990s. However, the Central government found it quite difficult to realise this goal. The fiscal situation in fact deteriorated in 1993-94 and the fiscal deficit of the Central government once again rose to 7.01 per cent of GDP. The States never committed themselves to any fiscal adjustment programmes. Under these circumstances the fiscal deficit of the Centre and the States taken together did not roll back from about 9.4 per cent in 1990-91 to an average of 7.0 per cent during the Eighth Plan period as stipulated. Since 1999-2000 both Central and State governments have failed to reduce fiscal imbalance substantially and in 2005-06 combined fiscal deficit of the Centre and the States was as large as 7.5 per cent of GDP.

In India, the fiscal imbalance has been caused mainly by unjustified lowering of tax rates and imprudent increase in public expenditure. Therefore, reduction in the fiscal deficit-GDP ratio is to be brought about by raising the tax revenue as well as containing public expenditure. At present, tax - GDP ratio is not quite

high which leaves some scope for additional resource mobilisation through tax-sources. The government expenditure which was about 19 per cent of GDP in 1970-71 rose sharply to about 25.9 per cent by 1980-81 and stood at 28.5 per cent of GDP in 1990-91. Therefore, if fiscal imbalance is to be corrected, it is necessary to reduce the government expenditure to around 25 per cent of GDP. However, in 2005-06 the government expenditure constituted 28.3 per cent of GDP which explains why the combined fiscal deficit of the Centre and the States in this year was as much as 7.4 per cent of GDP. Hence, containment of public expenditure is absolutely essential, but enough care should be taken to see that the government's capital expenditures in key infrastructural and social sectors are not curtailed. This would require concerted effort at containing the revenue expenditure, particularly the consumption expenditure of the government consisting mainly of defence expenditure and administrative expenditure, subsidy payments and interest payments.

Although for the purpose of fiscal adjustments containment of the government expenditure should receive overriding priority, some effort at additional resource mobilisation through tax and non-tax sources may also be necessary in the short-run. In 2005-06 the government revenues were 20.5 per cent of GDP. It is generally agreed that the revenues of the government should be around 25 per cent of GDP. In India, since built-in revenue elasticity with respect of GDP is around unity, almost all the increase in revenue has to be obtained from additional revenue mobilisation efforts. The Planning Commission has stated, "The required additional revenues may have to be generated by a judicious mixture of broadening the tax base, rationalising the tax rates and through non-tax sources."[3] The government can also mobilise some resources by targeting black income which presently is estimated to be at least 40 per cent of GDP.

An area where there is considerable scope for revenue mobilisation is public services. User charges on publicly provided utilities such as irrigation, electricity, water, road transport and higher education are much below their cost of provision. The overall recovery rates on services provided by the Central government are as low as about 35 per cent. They are even lower at about 14 per cent for the services provided by the State governments. Hence, unrecovered costs of public utilities are large and are a kind of subsidy to the users. ***The government can justifiably raise user charges on public utilities like electricity, irrigation, transportation and water.***

The government, however, does not seem to be serious about additional resource mobilisation through raising the recovery rates on public utility services. It has also failed to cut down its consumption expenditures and subsidy payments. Its interest payments continue to increase as there is no serious attempt to liquidate substantial part of the existing stock of internal debt. Having failed in adopting hard corrective measures, the government has opted for some soft options such as reduction in capital expenditures and social services in real terms. A fall in capital expenditure by government is generally expected to cause an overall decline in the rate of capital formation, while the containment of expenditure on social services adversely affects the human well-being. During the first decade of economic reforms India faced a decline in the rate of capital formation due to sharp squeeze on budgetary capital expenditure. The rate of gross capital formation in the public sector fell from 9.3 per cent of GDP in 1990-91 to 7.4 per cent in 2005-06. In the private sector, the rate of gross capital formation rose from 14.7 per cent of GDP in 1990-91 to 23.6 per cent of GDP in 2005-06. This uptrend in the private sector investment sustained the overall rate of domestic capital formation during the 1990s which stood at 33.6 per cent in 2005-06 as against 26.3 per cent in 1990-91. Adverse effects of reduction in expenditure on social services are not quantifiable in a short period. Nonetheless they are always there and would be clearly visible in the long period.

Balance of Payments Adjustment

At present, the balance of payments situation looks comfortable in contrast to that in 1990-91. The level of foreign exchange reserves has risen from a meagre $ 2.2 billion in March 1991 to more than 200 billion in April 2007. This accumulation of foreign exchange reserves suggests that the Indian currency has moved to a somewhat stable and sustainable balance of payments position in the last sixteen years. The current account deficit was 3.3 per cent of GDP in 1990-91 but fell to 0.4 per cent in 1991-92 mainly due to import compression which in turn adversely affected the overall performance of the economy. The government adopted a policy of import liberalisation in 1992-93 considering a relatively comfortable foreign exchange reserve position. This raised the balance of trade deficit from $ 2,798 million in 1991-92 to $ 5,447 million in 1992-93 and in the process the current account deficit climbed to 1.8 per cent of GDP. At this juncture the situation appeared to be slipping out of control but in 1993-94 an impressive growth of exports of the order of 20.2 per cent reduced the trade deficit bringing down the current account deficit to 0.4 per cent of GDP.

The trade deficit widened to $ 9,049 million in 1994-95. This was due to a higher import growth of 34.3 per cent and lower export growth of 18.4 per cent. However, there was some improvement in the invisible account. Hence, the year 1994-95 ended up with a current account deficit of about $ 3,369 million which was around 1.0 per cent of GDP. This was a sustainable balance of payments position and was not expected to present any financial problems. The current account deficit, however, rose to 1.7 per cent of GDP in 1995-96. This reflected the higher availability of external resources to bridge the higher saving- investment gap. Developments on the trade account during 1996-97 eased the pressure on the current account of the balance of payments and the current account deficit declined to 1.2 per cent of GDP in 1996-97 and further to 0.5 per cent of GDP in 2000-01. In 2001-02 there was a surplus in the current account of the order of 0.7 per cent of GDP. This rose further to 1.2 per cent of GDP in 2002-03 and 2.3 per cent in 2003-04. These surpluses in current account occurred mainly due to large positive invisible balance in these years. The trade balance in all these years was negative. There was deficit in current account of 0.4 per cent of GDP in 2004-05 and 1.1 per cent of GDP in 2005-06.

Policies relevant to the balance of payments which were adopted during the last sixteen years were guided by both stabilization and structural reform considerations. In India's case, the balance of payments problems arose largely from inadequate coverage of imports by export earnings. In the beginning of the 1980s, this coverage ratio was only 52.4 per cent and led to a massive trade deficit. There was some improvement in it during the 1980s and in 1990-91 export earnings accounted for about 66.2 per cent of the value of imports. Obviously even this was an unsustainable position which required a series of moves on the exchange rate front and exchange rate regime.

To begin with, in July 1991, there was a devaluation of rupee of about 18-19 per cent. This was followed by the liberalised exchange rate management system (LERMS) in the Budget for 1992-93. Under this system a dual exchange rate was fixed under which 40 per cent of foreign exchange earnings were to be surrendered at the official rate while the remaining 60 per cent were to be converted at a market determined rate. The 1993-94 Budget adopted the unified exchange rate regime under which the 60:40 ratio was extended to 100 per cent conversion. Thus India has been following the market determined exchange rate system since 1993. The experience with this system has been satisfactory as the period since 1993 has been marked by orderly conditions in the foreign exchange market, excepting a few episodes of volatility. The exchange rate management policy has been a policy of 'managed float regime' — *i.e.* the Reserve Bank has focused on managing volatility with no fixed target while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderely way. This policy has stood the test of time as it has ensured a judicious mixture of 'flexibility' and 'pragmatism'.

STRUCTURAL REFORMS

Since July 1991 comprehensive structural reforms have been undertaken to improve the supply-side of the economy. Among these the more important ones are:

1. Trade and capital flows reforms;
2. Industrial deregulation;
3. Public sector reforms and disinvestment, and
4. Financial sector reforms

Trade and Capital Flows Reforms

Since July 1991, the government has introduced a series of reforms in the trade sector which will help integration of the Indian economy better with the rest of the world. ***Among these reform measures, devaluation of rupee in July 1991 and subsequently its depreciation against the currencies of the leading industrialised countries, introduction of the convertibility of the rupee first on trade account and then for the entire current account transactions, liberalisation of import regime, substantial reduction in customs tariff rates, decanalisation of many items of trade and wide ranging measures to give a thrust to exports are important.***

The system of fixed exchange rates was abandoned by India in September 1975 and since then the system of managed exchange rate float has been in operation. Under the new system the rupee was not expected to appreciate against other currencies, causing a decline in the international competitiveness of the Indian exports. However, due to higher rate of inflation in India as compared to that in the developed countries, the real effective exchange rate of rupee did not fall as much as the nominal effective exchange rate of the rupee. Hence, as already written earlier, the government formally devalued rupee by around 18-19 per cent in July 1991 to

restore India's international competitiveness. This was followed by a liberalisation of the foreign trade regime through dismantling of some physical controls.

As a first step towards a gradual reduction in the tariffs, the 1991-92 Budget had reduced the peak rate of import duty from more than 300 per cent to 150 per cent. The process of lowering the customs tariff rate was carried further in subsequent Budgets. The 1995-96 Budget reduced the peak rate of import duty from 65 per cent to 50 per cent. This was reduced to 40 per cent in the 1997-98 Budget, to 25 per cent in the 2003-04 Budget, to 15 per cent in the 2005-06 Budget and finally to 10 per cent in the 2007-08 Budget.

Over the past few years not only substantial import duty cuts have been made in the case of machine tools, steel ores and concentrates, leather industry, electronics and telecommunications sectors, but the prevailing system of import duties has also been considerably rationalised with the purpose of establishing a parity in prices of goods produced domestically and internationally.

Earlier a large number of exports and imports used to be canalised through public sector agencies. ***During the past twelve years a large number of export and import items have been decanalised.*** Decanalisation of imports and exports as it has been done in recent years is an important step towards opening of more areas of the external sector to the private sector.

The government had undertaken wide-ranging measures to promote exports even prior to 1991 but even then the coverage of imports by export earnings were quite low. In 1990-91 this coverage ratio was only 66.2 per cent and led to massive trade deficit. However, over the years the situation has improved and in 2003-04 export earnings accounted for 82.9 per cent of the value of imports. As a result of liberalisation of imports the situation once again reversed and in 2005-06 coverage ratio was as low as 67.0 per cent. Apart from the system of Eximscrips and liberalised exchange rate mechanism which were shortlived, the government adopted a variety of export promotion measures. The important measures introduced were—establishment of Export Oriented Units for promoting exports from the agricultural and allied sectors, simplification of Export Promotion Capital Goods Scheme, introduction of Export Promotion Capital Goods scheme for the services sector, adoption of a more rational and convenient criterion for recognition of export houses/trading houses/star trading houses, broadening of areas of activity in Export Processing Zones, duty free import for exports under advance licensing scheme, and creation of an exporters' grievance cell in the Ministry of Commerce to facilitate action on problems being faced by exporters. Besides these, some more schemes/measures have been introduced to accelerate the country's transition to a globally-oriented economy, to stimulate growth by providing access to capital goods, intermediates and raw materials, to enhance technological strengths of the economy and thereby improving the global competitiveness of Indian exports and to provide consumers with good quality of products.

The government has also liberalised capital flows in the form of foreign direct investment as a part of the package of external sector reforms. Now FERA has been replaced by Foreign Exchange Management Act (FEMA). Foreign companies are now allowed to use their trade marks, accept appointment as technical or management advisers, borrow and accept deposits from the public and repatriate profits.

Industrial Deregulation

Historically, India's domestic economic activities have been subject to a wide array of physical controls. In the industrial sector, such controls took various forms: industrial licensing which regulated entry and expansion; reservation of a large number of industries for the public sector as well as small scale sector; time consuming procedures required for the exit of industrial units; and price and distribution controls on various industrial products. Jagdish Bhagwati and Padma Desai have been highly critical of this regulatory system.[4] Isher J. Ahluwalia also blamed the industrial licensing system and bureaucratic controls for the industrial stagnation during the second half of the sixties and the seventies.[5] The long time taken by the industrial licensing authorities to give clearance to the various proposals made it impossible for any project of importance to be completed within the scheduled time period. The industrial licensing authorities often took exception to the attempts of the industrial units to produce more than licensed capacity. Thus the objective of maximisation of output from a given licensed capacity got undermined. Policy of control resulted in misallocation of resources and encouraged complete disregard to costs. Moreover, the industrial licensing system as it had evolved over the years, had become a source of political and bureaucratic corruption and was being used by powerful vested interests to throttle competition.[6]

Limit on the size of the companies which was earlier enforced under the Monopolies and Restrictive Trade Practices Act has now been scrapped. This will allow industrial units to grow to optimum size and enjoy the benefits of economies of scale. The anti-monopoly legislation until this relaxation was made, had prevented

many firms from growing to optimum size and thus achieve higher efficiency levels. The industrial location policy has been both simplified and liberalised. The phased manufacturing programme under which domestic manufacturers were required to increase the domestic input-content of their products in a specified period has also been abolished under the new industrial policy. It is widely believed that these relaxations of the regulatory apparatus governing the industrial activity in this country in the past have considerably eased the entry barriers which should make the industrial sector more competitive both domestically and internationally. However, a major limitation to the structural reform in the industrial sector is that it has failed to evolve appropriate rules and procedures regarding exit of unviable industrial units. The existing industrial exit policy is highly restrictive and time-consuming. This is one factor which has led to widespread industrial sickness.

In recent years, it has been increasingly realised that the regulatory device has led to widespread inefficiency in the industrial sector. The government had, therefore, relaxed some of these controls even before it committed itself to structural reforms in 1991. The thrust of the new industrial policy announced in July 1991 is on deregulation of the industrial economy in a substantial manner and opening up a large number of industries to the private sector. ***The requirement of industrial licensing has been abolished for all but 5 product categories.*** These are alcohol, cigarettes, hazardous chemicals, industrial explosives, and electronic aeroscape and defence equipment, and drugs.

In another significant step the number of industries reserved for the public sector has been reduced from 17 to 3. Now core industries like iron and steel, electricity, air transport, ship building, heavy machine industries and telecommunication cables and instruments have been opened for the private sector.

Public Sector Reforms and Disinvestment

The public sector was originally intended to be the engine of self-sustained economic growth. It was also conceived to hold the commanding heights of the economy and to lead to technological advance. In order to fulfil these roles, it was necessary for the public sector to generate adequate investible surpluses. No doubt public sector contributed significantly to the expansion of the industrial base. Its role in diversifying the industrial structure has been no less. However, it has failed to generate sufficient internal resources for its further expansion and, as a result, has now become a major constraint on economic growth. Under structural reforms the government has decided to give greater managerial autonomy to public enterprises to enable them to work efficiently. In addition to this, two other key elements of the government's strategy for public enterprise reform are the promotion of increased private sector competition in areas where social considerations are not paramount and partial divestment of equity in selected enterprises.

Equity amounting to Rs. 49,214.03 crore in select public sector undertakings was disinvested (against the target of Rs. 96,800 crore) to public sector financial institutions, mutual funds and general public till 2005-06. Initially the government had talked of disposing off burdensome loss-making PSUs while well performing PSUs were to be given autonomy to enable them to develop as global Indian multinational corporations. However, there is virtually no evidence of any such initiative in practice. ***The government policy seems to be entirely limited to selling off shares of prime PSUs with the aim of bridging budget deficits.***

In India, there is a lack of enthusiasm for outright privatisation, which seems to many experts to be justified. Privatisation often fails to yield allocative efficiency because output is sub-optimal in the absence of an effective anti-trust law. Further, as Bimal Jalan points out, the sale of public enterprises would be of little help unless macroeconomic environment is improved and it is quite probable that if macroeconomic stabilisation is successful, disinvestment of equity in public sector enterprises may not be necessary.[7] But this viewpoint is not shared by many. It is often argued that there are strong reasons for disinvestment in public sector undertakings. R.K. Mishra *et al* point out that disinvestment of shareholdings enables public sector undertakings in acquiring their corporate identity whereby they can "keep pace with the market dynamism flowing from quick business reflexes resulting from their being distanced away from the government."[8] Further, disinvestment permits public enterprises to develop their own financing plans reducing thereby their dependence on the government. In any case, these have never been the considerations behind disinvestment deals. ***There is now considerable evidence to believe that disinvestment exercise has become a device to transfer public assets to private corporates at throwaway prices.*** In February/March 2001 Bharat Aluminium Company (BALCO)—a profit making PSU estimated to be worth more than Rs. 5,000 crore was squandered away for one-tenth of its value in a sleazy deal. There is now considerable evidence to believe that shares of public sector undertakings are usually undersold creating suspicion against the highest and the mightiest.

Financial Sector Reforms

A vibrant, efficient and competitive financial system is necessary to support the structural reforms in the real economy. Over the years, the Indian banking and the financial system has made impressive progress in terms of both geographical spread and functional reach. Despite this gain, there has been a steady erosion of the operational efficiency of the banking system. The Eighth Five Year Plan document points out.

"The balance sheet of the performance of the financial sector is thus mixed, strong in achieving certain socio-economic goals and in general widening the credit coverage but weak in viability."[9]

The government, therefore, set up a Committee on Financial System (CFS) under the chairmanship of M. Narasimham, to examine the country's financial system and its various components and to make recommendations in respect of the following:

1. For improving the efficiency and effectiveness of the financial system, with special reference to economy of operations, accountability and profitability.
2. For infusing greater competition into the financial system so as to enable the banks and other financial institutions to respond more effectively to the credit needs of the economy.
3. For ensuring appropriate and effective supervision over the various entities in the financial sector, in particular the commercial banks and term lending institutions.

The Committee was also required to review the existing legislative framework and to suggest necessary amendments for implementing the recommendations.

The report of the CFS was placed before the Parliament in December 1991, and has since then become the basis for introducing reforms in the banking sector. The major reform measures undertaken during the past few years are as follows:

1. The level of the statutory liquidity ratio (SLR) and the cash reserve ratio (CRR) were progressively raised during the 1980s for combating inflationary pressures generated by large budgetary deficits. This, however, adversely affected the profitability of banks and pressurised them to charge high interest rates on their commercial sector advances. The government has over the years brought down both statutory liquidity ratio and cash reserve ratio in a phased manner. ***The effective statutory liquidity ratio has been lowered down to 25 per cent.*** The cash reserve ratio was also brought down to 4.5 per cent with effect from June 14, 2003. However, to check liquidity overhang in the system the RBI hiked the CRR to 5 per cent in October, 2005. It was raised to 7.50 per cent in November 2007.

2. The RBI has introduced new prudential norms in respect of income recognition, classification of assets, provisioning of bad debts and capital adequacy. The minimum capital standards were prescribed in accordance with the Basel Committee norms under which banks were required to maintain unimpaired capital funds equivalent to 8 per cent of the aggregate of the risk weighted assets. Banks were expected to touch 8 per cent capital to risk weighted asset ratio (CRAR) by March 1996. Foreign banks operating in India and Indian banks operating abroad were, however, required to attain 8 per cent by March 1993 and March 1994 respectively. The CRAR was raised to 9 per cent from the year ended March 2000. At end March 2006, CRAR for nationalised banks stood at 12.3 per cent, for new private sector banks at 12.6 per cent and for foreign banks 13.0 per cent. Thus, ***the CRAR for all banks is now substantially higher than the minimum requirement of 9.0 per cent.***

3. The Central government provided budgetary support of Rs. 20,046 crore for recapitalisation of public sector banks till 1997-98. This, however, was not sufficient for achievement of norms by all banks. Hence banks had to raise debt and equity resources from the public.

4. The earlier formats of the balance sheet and profit and loss account did not reflect the true financial position of the banks. Hence, they have been revised and made effective from the bank accounting year 1991-92.

5. Commercial banks attaining capital adequacy norms and prudential accounting standards have been given freedom to set up new branches without the approval of the RBI. Banks can now also rationalise their existing branch network by relocating branches, opening of specialised branches, setting up controlling offices etc.

6. The RBI has announced guidelines for setting up banks in the private sector. These banks should be financially viable and should avoid concentration of credit and crossholdings with industrial groups. Further, they will have to observe priority sector lending targets as applicable to other banks.

7. Number of interest rates slabs on banks advances were reduced from about 20 in 1989-90 to 2 in the financial year 1994-95. This attempt to unify interest rate structure aims at reducing the degree of cross-subsidy

in the banking system. Moreover, interest rates in the banking system have been liberalished, compared to the situation prevailing before 1990. According to Montek S. Ahluwalia, ***"The rationale for liberating interest rates in the banking system was to allow banks greater flexibility and encourage competition"***[10]

8. The supervisory system of the RBI has been strengthened with the establishment of a new Board for Financial Supervision under the chairmanship of Deputy Governor of the RBI. The Board ensures implementation of the regulations with respect to credit management, asset classification, income recognition, provisioning, capital adequacy and treasury operations.

9. Agreements between the RBI and public sector banks have been made to improve the management and the quality of the performance of the latter. This includes management information system and the internal audit and control mechanism.

10. Recovery of debts due to banks and other financial institutions in the past have been unsatisfactory. Hence, an Act was passed in 1993 under which Special Recovery Tribunals have been set up to facilitate quicker recovery of loan arrears.

11. The guidelines for determining the maximum permissible bank finance have been made more flexible. Banks will now have greater freedom in determining the working capital needs of the borrowers and responding to local requirements in an appropriate manner.

Following the recommendations of the Narasimham Committee on Financial System (CFS) the above reform measures were undertaken. Meanwhile major changes had taken place in the domestic economic and institutional scene. Also, there was a movement towards global integration of financial services. Under the circumstances, banking system had to be stronger and better equipped to compete effectively in a fast changing economic environment. The government thus appointed the Committee on Banking Sector Reforms (CBSR) under the chairmanship of M. Narasimham. The Committee (CBSR) submitted its report in April 1998. Its major recommendations are as follows:

1. Strong banks should be merged and relatively weak and unviable ones should be closed. Mergers between banks and development financial institutions may be considered if it makes economic and commercial sense.

2. The country should have two or three banks with international orientation, eight to ten national banks and a large number of local banks. The third-tier banks should remain confined to smaller geographical regions. The first and the second tier banks shall take care of the needs of the corporate sector.

3. The Committee recommended new and higher norms for capital adequacy. It suggested that the minimum capital to risk assets ratio (CRAR) be increased to 10 per cent from its earlier level of 8 per cent.

4. Budgetary support for recapitalisation is not viable and should thus be abandoned.

5. Legal framework is not adequate for credit recovery. It should be strengthened.

6. Net non-performing assets for all banks be brought down to below 5 per cent by the year 2000 and to 3 per cent by 2002.

7. There should be rationalisation of branches and staff.

8. Banks boards should be depoliticised under the RBI supervision.

9. The policy of licensing new private banks may be continued.

10. Foreign banks may be allowed to set up subsidiaries or joint ventures in India. Such subsidiaries or joint ventures should be treated on par with other private banks and subject to the same conditions with regard to branches and directed credit as these banks.

11. There has to be an integrated system of regulation and supervision to regulate and supervise the activities of banks, financial institutions and non-bank finance companies. The agency for this purpose be renamed as the Board for Financial Regulation and Supervision (BFRS).

The second half of the 1990s saw the dangers associated with the mindless liberalisation in the financial sector world over. Incidents like those of Barings Bank and the bank failures during the South-East Asian crisis exposed the problems which arose from inadequate regulation and supervision of banks. Hence the ***Committee on Banking Sector Reforms under the chairmanship of M. Narasimham particularly stressed on prudential measures like the increase in the Capital to Risk-Weighted Assets Ratio (CRAR), the introduction of market risk on government securities, the stricter Non-Performing Assets (NPAs) norms and provisioning requirements and the introduction of asset-liability management guidelines, and risk management guidelines.***

In line with these recommendations of the Second Narasimham Committee a gamut of measures to strengthen the banking system have been announced. Important measures from this point of view are: ***raising the CRAR to 9 per cent, strengthening prudential accounting norms, laying down Asset Liability Management (ALM) and risk management guidelines and directing the banks to provide additional information in the 'Notes to Accounts' in the balance sheets to increase transparency.***

AN APPRAISAL OF ECONOMIC REFORMS

Since July 1991 the government has undertaken both stabilisation programmes and structural reforms as two components of the economic reform package. There is now considerable evidence to suggest that the avowed objectives of the stabilisation and structural reform programmes have not been completely achieved. The annual point to point rate of inflation was around 6.1 per cent on January 20, 2007. ***Fiscal imbalances were not corrected and the gross fiscal deficit of the Central government alone was as high as 5.9 per cent of GDP in 2002-03. Considering the Centre and the States together the fiscal deficit was as high as 9.6 per cent of GDP in 2002-03*** . Only after the enactment of Fiscal Reform and Budget Management Act ***(FRBM Act) the fiscal deficit of the Central Government has declined and it was 4.1 per cent of GDP in 2005-06. The combined fiscal deficit of the Centre and States was 7.45 per cent of GDP in 2005-06. The only apparent sign of success is to be seen in the external sector where the stock of foreign exchange reserves was as high as $ 240 billion in September 2007.***

In the real sectors, the structural reforms showed mixed results. In 1991-92 there was near stagnation. However, since 1991-92 during the twelve years upto 2003-04, GDP increased at the rate of 5.7 per cent per annum. In the first two years of structural reforms, there was near stagnation in the industrial sector. However industrial production picked up in 1993-94 and the average rate of growth of industrial production during the Eighth Plan turned out to be 7.4 per cent per annum (same as the target), Industrial production slowed down in the latter half of 1990s with the result that the average rate of growth during the Ninth Plan was only 5.0 per cent per annum which was considerably less than the Ninth Plan target of 8.2 per cent per annum. Rate of growth of industrial production picked up considerably to 8.9 per cent per annum, on an average, during the Tenth Plan period (2002-07) although it was below the target of 10.0 per cent per annum. Since 1990-91 there was a steep fall in both savings and investment rates for three years. However, both savings and investment rates showed an upturn in 1994-95 but again declined in 1996-97 and were at modest levels in 2002-03. However, thereafter, both savings and investment rates show sharp increases. Some economists have questioned these figures. They have argued that in these years errors and omissions were large and their values have raised the rates of savings and investment substantially.

These gains from structural reforms notwithstanding, the economic reforms have been subjected to various criticisms.

The *EPW* Research Foundation has pointed out that ***"the new economic policy is seriously flawed in conception... in its contents, strategy and approach and in many other respects."***[11] The shortcomings can be broadly classified under five major categories:

(*i*) absence of a broader development strategy;
(*ii*) wrong sequencing of reforms;
(*iii*) hasty pace of reforms;
(*iv*) prerequisites of reforms ignored; and
(*v*) absence of human development goals as an integral part of the strategy.

These limitations are interrelated and together expose the inherent flaws in the stabilisation and structural reforms measures undertaken so far.

1. Absence of a broader development strategy. The focus of both macroeconomic stabilisation and structural reforms is to create a competitive environment in industry in which entrepreneurial decision-making will depend entirely on the market forces. ***The government's new industrial policy therefore lacks a well defined strategy and a role for the State.*** The South-East Asian countries which recorded high rates of industrial growth during the three decades period from mid-1960s to mid-1990s, in contrast, did so on the basis of some structured blueprints and by a process of significant market intervention. The case of industrialisation in South Korea is quite revealing. The government in this country steadfastly pursued a policy of heavy industrialisation despite the stiff opposition from the IMF and the World Bank. Judged against the experiences of these countries, the interventionist strategy of the government in this country can be criticised only for lack

of dynamism. On the basis of our experience in the past it is patently wrong to conclude that a well articulated industrial strategy and heavy State intervention have no positive role to play in accelerating industrial growth.

2. Wrong sequencing of reforms. As a result of wrong sequencing of reforms, serious distortions have surfaced in economic management. There are at least three examples of wrong sequencing of reforms. First, while for drastic reduction in fiscal deficit, revenue deficit and even budget deficit, the prerequisites are decisive reduction of non-development expenditure and widening the tax base, the government has initiated fiscal correction programme with surrendering of revenue through substantial reductions in tax rates and compression of capital expenditure. Second, a more obvious case of inappropriate sequencing relates to compression of government's capital expenditure and contraction of public investment before ensuring that the private sector and the foreign investors will fill the gap. The third case of flawed sequencing is of liberalising imports of capital goods before adopting a strategy for technology advancement of the domestic capital goods sector. The latter was necessary for pursuing an outward oriented strategy of economic growth.

3. Hasty pace of reforms. The hasty pace of reforms has been determined by the controversial goal to globalise the Indian economy quickly. This has led to rapid deterioration in the quality of industrial structure. *EPW* Research Foundation points out, "A sharp reduction in industrial growth, reduction in the growth of capital goods' industries, a relative shift of exports away from manufactures, and arresting of the growth of industrial employment, have been some of the glaring effects of rapid reforms without providing for some breathing time and appropriate checks and balances for the Indian industry."[12]

4. Prerequisites of reforms ignored. ***The literature on stabilisation and structural reforms is full of evidence that the shocks of these policies are better absorbed and their consequences for the well-being of the masses are very much reduced if the society has already reached a certain minimal level of human development.*** South Korea, Malaysia, Thailand and Indonesia are the recent successful cases but in all these countries not only the socio-economic structure was far more egalitarian due to land reforms and such other measures but the human development indices like life expectancy and literacy rates were at higher levels, while infant mortality was at a lower level before they embarked on significant structural reform programme. In contrast, the Indian situation is not at all encouraging from the point of view of human development and socio-economic structures.[13]

5. Absence of human development goals as an integral part of the strategy. ***The stabilisation and structural reform programme in India is being implemented against a background of incomplete structural transformation, widespread poverty, low level of human development and distorted pattern of expenditure on health and education oriented towards the relatively well off sections of the society.*** Given these dismal conditions and a low rate of economic growth, structural reforms must be undertaken with a human face. This requires that human development goals should be an integral part of the strategy of structural adjustment. Unfortunately in India no such attempt has been made.[14]

Suresh D. Tendulkar and T.A. Bhavani in their recent book, *Understanding Reforms — Post 1991 India* wholeheartedly support the growth promoting direction of ongoing 1991 economic reforms in India. They firmly believe that it would help in achieving the long cherished social objectives quickly and more effectively.[15] They, however, seem to ignore the fact that rapid economic growth by itself does not ensure reduction in poverty and income inequality. Growth may be jobless as it has been in India in recent years, and it may increase both unemployment and incidence of poverty. Thus separate policy measures have to be pursued for realising the objectives of social and economic equity. Neo-liberal reforms with their growth orientation invariably fail to eradicate poverty and often increase income inequality.

C.T. Kurien is highly critical of neo-liberal reforms of 1991. His contention is that the reforms did not bring about any spectacular achievements, contrary to the claims of the original architects of economic reforms. According to Kurien, "The payments crisis of the 1991 was averted but elaborate reforms of the kind being pushed were hardly necessary to achieve that objective..."[16]

In Kurien's opinion, within the economy though growth rate has moved up, the performance is far from satisfactory. After sixteen years, the different people are looking at reforms from their own perspectives. First, we have the upper class, very happy with the reforms. They have all the white goods domestically produced as well as imported ones. Then we have the middle class which sees in this an opportunity for its advancement to move to the upper class. Finally, there is the lower class which asks, "What is there in this for us ?" The poor people want jobs and lower prices of commodities they wish to consume and not merely the good things of life which rich people ordinarily consume. ***"The beneficiaries of the reforms so far have been clearly the industrial and commercial classes who were able to take advantage of the opening up of the economy, the liberalisation, and the productive and more so speculative activities they have given rise to."***[17]

Parathasarathi Shome and Hiranya Mukhopadhyaya have examined at length whether India's economic reforms of the 1990s are sustainable. Their analysis shows that ***both stabilisation measures and structural reforms lack sustainability.***[18]

Kamal Nayan Kabra underlines that ***liberalisation policies of the 1990s seek to accelerate growth ignoring disequalisation which is an inevitable effect of economic reforms being pursued in this country.*** A brief extract from Kabra's article "Disequalising Growth : The Achilles' Heel of Liberalisation" is being reproduced in Box 18.2 for the benefit of readers who may not have access to Kabra's published article.

BOX 18.2. **Disequalising Growth during the Liberalisation Decade**

Liberalisation seeks to accelerate growth by giving an uncontrolled, unregulated state supported free run of the economy to the well-to-do sections to make investments and run their enterprises in a manner they find 'rational' and profitable in a globalising economy. Thus freedom and support turns out, in effect, to be the exclusive preserve of the large owners, controllers and mobilisers of financial, technical and managerial resources and of public policy support in the competitive game. Thus, the unorganised sector and the people of small means face a squeeze owing to uneven competition from the free and lower duty imports as well as the state supported and internationally linked local corporates behemoths. Huge hoards of black incomes and wealth with the richer sections create further hurdles for the not-so-rich and the emerging entrepreneurs due to the unchanging wooden, and generally unscrupulous bureaucracy. The small industries existence has been threatened by de-reservation of several industries that used to be their preserve. Liberalisation has not spared the retail trade and the rural sector either.

Source : Kamal Nayan Kabra : "Disequalising Growth : The Achilles' Heel of Liberalisation" in *Alternative Economic Survey, India 2004-2005* (Delhi, July 2005), p. 38.

LONG-TERM GROWTH PROSPECTS

We have discussed above the economic reforms of 1991. Now we propose to examine India's long-term growth prospects. The GDP growth rate has been more or less the same in the 1990s as in the 1980s . ***Only for three years from 1994-95 to 1996-97 the GDP growth rate was around 7.5 per cent per annum which created an illusion in the government circles that the economy had ultimately moved to a high growth path as a result of the reform measures.*** However, the economy once again reverted to a modest growth path. The economy had a higher growth rate in the 1980s as compared to the growth rate of 3.5 per cent per annum during the three decades period from 1950-51 to 1979-80. The growth process of the 1980s was, however, not sustainable because it involved a high fiscal deficit which, in turn, caused inflation and balance of payments problems. Another criticism of the growth process of the 1980s was that, in the absence of liberalisation, the bureaucratic control of industrial production and trade activities resulted in inefficient utilization of resources.

Since the initiation of reforms there has not been a significant decline in the fiscal deficit of the Central government. However, pressure on inflation and balance of payments has been somewhat eased. But the key question now is whether the Indian economy in the coming years will be able to realize a long-term growth rate of 8.5 per cent or above. The World Bank lobbyists in India who masquerade as liberalisers are quite hopeful. Their contention is that the saving rate of 27-28 per cent in recent years is satisfactory by comparison with other countries at a similar stage of development. This rate of saving can rise further by 2-3 per cent with continued 'fiscal reforms.' The reform measures introduced by the government should be able to attract foreign investment of $ 7-8 billion per year which will enable our investment rate to rise by about 3 per cent. Thus investment rates of 28-30 per cent of GDP are realisable in India and this can support GDP growth of 9 per cent per annum at the existing level of efficiency in capital utilisation. The government has thus decided that the Eleventh Five Year Plan will have a GDP growth target of 9 per cent per annum. Some economists in this country are, however, sceptical about these arguments. Kamal Nayan Kabra opines that the record of growth during 2002-03 and the preceding period since 1991-92 shows that the expectations from adoption of the structural adjustment programme seem to have remained elusive. ***The main factor that contributed to growth during the 1990s is the disproportionately high rate of growth of the non-goods producing services sector.*** "The hyper growth of the financial sector, as seen during this period is dysfunctional especially so far as it made the economy exposed to more, larger and frequent financial scams, increased the volatility of the capital markets and gave rise to huge unearned incomes."[19] Shankar Acharya is not impressed by the services led growth of recent years. He argues, ***"Services are hugely important but they cannot by themselves assure rapid and sustained growth of the Indian economy."***[20]

In India, there are real dangers of speculations replacing genuine (long-term) investment and enterprise. As far back as 1936 J.M. Keynes wrote in *The General Theory of Employment, Interest and Money,* "As the organisation of investment markets improves, the risk of the predominance of specualation does, however, increase... Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious

when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."[21] Keynes's forceful description of the dangers of speculation replacing investment is very much relevant in the Indian context and thus should not be dismissed lightly. The Indian economy needs to snuff out two types of speculative activity if it wishes to escape currency turmoil similar to the one experienced by South-east and East Asian countries. The first type of speculative activity pertaining to domestic investment is a perennial problem. The second one relating to external transactions has become important because of enormous growth of international finance capital.

Making their observations on dangers of speculation, Arun Gosh *et al* argue, ***"Two points must be repeated in this context. First, speculation needs to be curbed both internally and externally, Secondly, this does not imply isolationism. We live in a globalised world. We must improve India's competitiveness through modernization. But equally, we must not open up the economy to speculative forces. That must remain different task of balancing."***[22]

Manoj Panda after analysing post-1991 macroeconomic scene reaches the conclusion "***that even 12 years after the initiation of economic reform measures in 1991, it is admittedly not possible to claim that the Indian economy has been put on a higher growth path compared to the 1980s***"[23]. Arun Kumar suggests that for future this country should adopt the philosophy of "last person first" propounded by Mahatma Gandhi. ***"Focus on poor will lead to a more stable growth path than the one the economy is currently on, which is based on the market mechanism".***[24] This change in approach will require increased public investments which in turn will induce private investments. This strategy may generate employment opportunities and will thus lead to growth with social justice.

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CHAPTER

19 GLOBALISATION AND ITS IMPACT ON INDIAN ECONOMY

Meaning and Levels of Globalisation
• Globalisation at the World Level • Globalisation at the Level of a Specific Country • Globalisation at the Level of a Specific Industry • Globalisation at the Level of a Specific Company
Factors Influencing Globalisation
Globalisation Strategy for a Company : How to become a Global Company?
• Turning Global Presence into Global Competitive Advantage
A Critique of Globalisation
Globalisation in India
• The 'Push' towards Globalisation
Steps towards Globalisation
• Exchange Rate Adjustment and Rupee Convertibility • Import Liberalisation • Opening up to Foreign Capital
Effects of Globalisation
• Effects on the External Sector • Effects on the Indian Enterprises

Globalisation has become an expression of common usage. It basically means 'integration' of different economies and societies across the world and has many dimensions — economic, political, social and cultural. Studying of all these dimensions is a stupendous task. Therefore, it becomes necessary to limit the discussion to some specific aspects of globalisation. In the present chapter, we shall limit our discussion to only the economic aspect and define globalisation accordingly. The questions that we propose to consider in this chapter are as follows:

What is globalisation ? What are the factors influencing globalisation ?
What strategy should a company adopt for globalising its operations ?
What steps have been taken by the Government of India towards globalisation ? What have been the effects of these steps ?

MEANING AND LEVELS OF GLOBALISATION

Globalisation means different things to different people. According to Deepak Nayyar, ***"It (globalisation) can be defined, simply, as the expansion of economic activities across political boundaries of nation States. More importantly, perhaps, it refers to a process of deepening economic integration, increasing economic openness and growing economic interdependence between countries in the world economy.*** It is associated not only with a phenomenal spread and volume of cross border economic transactions, but also with an organisation of economic activities which straddles national boundaries."[1] ***The important characteristics of globalisation are as follows:[2] (i) Rapid growth in international financial transactions; (ii) Fast growth in trade, especially among multinational corporations (MNCs); (iii) Surge in foreign direct investment, largely contributed by MNCs; (iv) The emergence of global markets; and (v) The diffusion of technologies and ideas through rapid extension of a globalised transportation and communication system.***

Depending upon the 'level' we choose to focus on, globalisation can be discussed under the following headings:

1. Globalisation at the world level.
2. Globalisation at the level of a specific country.
3. Globalisation at the level of a specific industry.
4. Globalisation at the level of a specific company.

Globalisation at the World Level

At a worldwide level, globalisation refers to the growing economic interdependence among countries as reflected in increasing cross-border flows of goods, services, capital and knowledge. For instance, world trade has increased considerably over the recent years. World exports which stood at $ 61 billion in 1950 rose to $315 billion in 1970, $ 3,447 billion in 1990 and further to $ 7,480 billion in 2003. During this entire period, the growth in world trade was significantly higher than the growth in world output. As a result, an increasing proportion of world output entered into world trade. The share of world trade in world GDP touched 32.5 per cent in 1990 and this rose further to 40.0 per cent in 2001.

There has been substantial increase in foreign direct investment (FDI) as well. Within a decade (1990 to 2000), FDI increased from $ 2,02,547 million in 1990 to $ 14,63,611 million in 2000 *i.e.* by almost seven times.[3]

Trading in foreign exchange markets and in world market for financial assets (*i.e.* cross border transactions in bonds and equities) has increased at a still faster rate. The enormity of foreign exchange transactions would be clear from the fact that in 1992 while world GDP was $ 64 billion per day and world exports were $ 10 billion per day, the foreign exchange transactions were of $ 900 billion per day. "It is also worth noting that daily foreign exchange transactions in the world economy were larger than the foreign exchange reserves of all central banks put together, which were $ 693 billion in 1992."[4] Trading in bonds and equities across countries has also registered a similar massive increase.

As is clear from the above, ***globalisation at the world level consists of two distinct phenomena—the globalisation of production and globalisation of finance.*** Globalisation of production has taken place at a rapid speed during the 1980s and 1990s. The driving force behind this has been the multinational corporations (MNCs). Because of stagnant demand and rising production costs in home countries, MNCs are shifting their production bases to the developing countries where the domestic markets for goods and services are expanding and the production costs are much lower, as raw materials and labour are very cheap. Since the developing countries are also rapidly opening up their economies under pressure from international agencies and MNCs and under various international commitments, the 'penetration' of MNCs in the developing countries is growing more and more widespread and deep. As noted by Todaro and Smith, MNCs, in effect, have become ***global factories*** searching for opportunities anywhere in the world.[5] In fact, the sales of 200 top corporations was as high as 28.3 per cent of world GDP in 1998. Thus, these 200 colossal corporations of the world control more than a quarter of the world's economic activity. The combined sales of these 200 top corporations was as high as $ 7.1 trillion in 1998—higher than the $ 6.9 trillion combined GDP of 182 countries.[6] Considering the fact that there are now some 40,000 MNCs operating in the world, the extent of the control exercised by the MNCs over world production and trade can be well imagined. The massive control of MNCs on world production is a clear indication of globalisation of production.

As emphasized by Kavaljit Singh, much more faster and much more influential than globalisation of trade in recent years has been the globalisation of finance. Historically, most trading in foreign exchange was the result of international trade as buyers and sellers of foreign goods required foreign currency for settlement of payments. Things have now changed drastically as only 2 per cent of global currency movements are on account of international trade. Financial flows are now rarely associated with the flow of real resources and long-term productive investments. They have acquired a 'life' of their own and are guided mainly by short-term speculative gains. The emergence of many new financial instruments like bonds, mutual funds, GDRs (Global Depository Receipts) and derivatives has contributed significantly to the globalisation of finance. According to an estimate made by the Bank for International Settlements (BIS) which monitors the transactions in the world's foreign exchange markets, $ 1.49 trillion ($ 1490,000,000,000) is traded on an average on a single day.[7]

Globalisation at the Level of a Specific Country

At the level of a specific country, globalisation refers to the extent of interlinkages between a country's

economy and the rest of the world. Some key indicators to measure the global integration of any country's economy are foreign trade (exports and imports) as a ratio of GDP, inward and outward flows of foreign direct investment and portfolio investment and outward flows of royalty payments associated with technology transfer. Table 19.1 compares the global integration of China and India with respect to some of the indicators in 1990 and 2001. As is clear from this table, China's economy has globalised much faster during this period than India's.

TABLE 19.1. Global Integration of China vs India

Indicator	*China*		*India*	
	1990	*2001*	*1990*	*2001*
Trade in goods as % of GDP	31.8	44.3	13.1	19.5
Trade growth *less* GDP growth (average %, 1990-2001)		6.2		5.6
Foreign direct investment ($ million)	3,487	44,241	237	3,403
External debt ($ million)	—	1,64,068	—	67,760
Short-term debt	9,317	43,920	8,544	2,951

Source: World Bank, *Little Data Book, 2003* (Washington, 2003), p. 64 and p. 109.

Globalisation at the Level of a Specific Industry

At the level of specific industry, globalisation refers to the degree to which a company's competitive position within that industry in one country is interdependent with that in another country. According to Vijay Govindrajan and Anil Gupta, "the more global an industry, the greater is the advantage that a company can derive from leveraging technology, manufacturing prowess, brand names and/or capital across countries."[8] Globalised industries tend to be dominated in every market by the same set of global companies, which coordinate their strategies across countries. For example the athletic footwear industry is dominated by Nike, Adidas and Reebok. "Key indicators of the globalisation of an industry are the extent of cross-border trade within the industry as a ratio of total worldwide production, the extent of cross-border investment as a ratio of total capital invested in the industry, and the proportion of industry revenue accounted for by companies that compete in all major regions."

Globalisation at the Level of a Specific Company

At the level of a specific company, globalisation refers to the extent to which a company has expanded its revenue and asset base across countries and engages in cross-border flows of capital, goods and knowhow across subsidiaries. "Key indicators of the globalisation of a company are international dispersion of sales revenues and asset base, intra-firm trade in intermediate and finished goods, and intra-firm flows of technology."[9] Vijay Govindrajan and Anil Gupta present Toyota as a good example of a highly globalised company. This is due to the reason that at the end of 1995, one-third of Toyota's global output came from wholly or partially owned affiliates in 25 foreign countries spread over the Americas, Europe and Asia. Moreover, Toyota exported 38 per cent of its domestic production from Japan to foreign markets and engaged in significant intra-firm flows among its affiliates. For example, within its south-east Asian regional network, Toyota exported diesel engines from Thailand, transmissions from the Philippines, steering gears from Malaysia and engines from Indonesia.

As is clear from the discussion on the levels of globalisation above, ***it is possible to talk of globalisation from a 'macro' point of view and from a 'micro' point of view.*** From the macro point of view, globalisation is the growing interdependence among countries of the world and the interlinkages between a country's economy and the rest of the world. Thus the first two 'levels' of globalisation discussed above fall in the category of 'macro' globalisation. Economists mostly concern themselves with this type of globalisation as they are more interested in macro parameters of the economy like growth in GDP of different countries, growth in world output and trade, growth in national employment levels, growth in trade and investment flows among countries, the balance of payments deficits and surpluses of different countries, growth in foreign exchange reserves etc. As against this, the management experts mostly concern themselves with micro aspects of globalisation as they are more interested in studying the global strategies of specific firms and industries, global competitiveness among firms and industries, challenges before the 'global' manager etc. However, these are not watertight

compartments but only convenient separation of the aspects of globalisation that weigh the mindsets of economists on the one hand and the management experts on the other. In fact, the economist would be as much interested in studying the behaviour of a Multinational Corporation as a management expert would be interested in studying the global economic environment in which a business operates.

FACTORS INFLUENCING GLOBALISATION

A large number of factors have influenced the process of globalisation. Prominent among them are as follows:

1. Dismantling of barriers to international economic transactions. The first step in the direction of dismantling of barriers to international economic transactions was ***'trade liberalisation'*** which led to an unprecedented expansion of international trade between 1950 to 1970. This was followed by the ***liberalisation of regimes for foreign investment*** leading to a surge in international investment which began in the late 1960s. ***Financial liberalisation*** came last, starting in the early 1980s. This had two dimensions: (*i*) the deregulation of the domestic financial sector in the industrialised countries, and (*ii*) the introduction of convertibility on capital account in the balance of payments.[10] Domestic financial liberalisation has encouraged market forces by reducing the role of the State in the financial sector. The demarcation lines between banks, insurance companies and finance companies have been considerably diluted, bond markets and equity markets have been liberalised, controls and regulations on both the inflows and the outflows of capital have been removed, and the growing institutionalisation of savings in the developed countries has given rise to institutional investors who are both willing and able to invest in global markets.

Winds of liberalisation are sweeping the developing countries as well. In order to meet the conditionalities of the economic stabilisation and structural adjustment programmes of the IMF (International Monetary Fund) and the World Bank, a large number of developing countries have 'opened up' their economies in recent years by deregulating the industrial and financial sectors, dismantling controls on imports and exports of goods and services, full or extensive liberalisation of exchange restrictions, easing controls on portfolio inflows and outflows etc.

2. Over-capacity and over-production. From the beginning of 1980s, the economies of the developed countries are suffering from over-capacity and over-production in manufacturing. As no major expansion is taking place in the world's market, capital is looking for profitable alternative opportunities. Such alternatives are provided by global financial markets where quick buck can be made. As a result, capital is shifting fast from investment in production to investment in financial markets and speculative financial instruments. Moreover, the interest rates in the developed countries are very low and this is prompting investors in these countries to park their funds in developing countries where rates of interest are substantially higher.[11]

3. Technological advances. Technological revolution in the field of transport, communications and information has played a crucial part in the progress of globalisation. The advent of computers and satellites leading to massive expansion in the field of information technology has revolutionised the entire communication system. The development and expansion of fax, e-mail, mobile telephones, the personal computer industry etc., has made communication across the world just a matter of minutes. The new information technology allows companies to run their business in ways that were impossible earlier and at a fraction of the price. The internet has added to the speed of transactions. Virtual stock exchanges are no longer a dream and twenty four hour trading has become a reality. The 'electronic money' has added momentum to capital mobility as funds worth billions of dollars can be transferred globally with much ease and speed with the help of globally linked electronic monitors. However, as noted by Kavaljit, ***"technological advances have also increased the speed at which market shocks are transmitted nationally and globally.*** Earlier, market shocks used to take days and weeks to spread from one country to another, now they can be transmitted instantly."[12]

4. Emerging forms of industrial organisation. New emerging forms of industrial organisation have also helped the processes of globalisation. According to Nayyar, "The emerging flexible production system, shaped by the nature of technical progress, the changing output mix and the organisational characteristics (based on Japanese management systems) is forcing firms to constantly choose between trade and investment in their drive to expand activities across borders. The declining share of wages in production cost, the increasing importance of proximity between producers and consumers and the growing externalisation of services are exercising a strong influence on the strategies and the behaviour of firms in the process of globalisation."[13]

5. Political factors. The political realities of recent times have helped globalisation. The process of globalisation beginning in the early 1970s has coincided with the political dominance of the United States as

a superpower. The downfall of communism and the disintegration of the Soviet Union has converted the 'bi-polar' world into a 'uni-polar' one with the United States of America becoming the super boss in the field of political decision-making and economic influence. Globalisation requires a dominant economic power with a national currency which is accepted as the equivalent of international money: as a unit of account, a medium of exchange and a store of value. This role is being performed by the US dollar. Its unchallenged supremacy in the economic and political fields has emboldened the USA to bully and pressurize the developing countries into towing its lines (if need be through the international bodies, like the UNO, IMF, World Bank and the WTO which it has come to control).

This unchallenged power of the USA and its control over the new emerging international economic order which is taking shape under the WTO, has become a serious threat to the sovereignty of nation-States.[14] Large global financial flows (running into trillions of dollars every day) moving in the world's financial markets in search of profit making opportunities from speculative investments, have also reduced the 'economic space' of the developing countries considerably. These flows are largely liquid and are attracted by short-term speculative gains, and can leave the country as quickly as they come. Such short-term speculative flows of money are termed ***hot money*** and have the potential of seriously jeopardising the economic policies of developing countries. This was very much evident through the currency crises in Mexico in 1994, and in the Southeast Asian countries in 1997.[15] Thus, the power of global finance has 'undermined' the nation-States.

6. The intellectual rationale. Economic theorising frequently follows in the steps of political reality. Accordingly it should not be surprising to find a large number of economists engaged in the task of formulating an intellectual rationale for globalisation. The essence of their arguments can be summed up as follows: (*i*) the government should reduce its interference as much as possible so that it conforms to the ideal of a 'minimalist State'; (*ii*) the market is not only a substitute for the State but is a better alternative because it performs better; (*iii*) resource allocation and resource utilisation must be based on market prices which should conform as closely as possible to international prices; and (*iv*) national political objectives, domestic economic concerns or even national boundaries should not act as constraints. "It is suggested that such policy regime would provide the foundation for a global economic system characterised by free trade, unrestricted capital mobility, open markets and harmonised institutions. And the ideologues believe that such globalisation promises economic prosperity for countries that join the system and economic deprivation for countries that do not."[16]

GLOBALISATION STRATEGY FOR A COMPANY: HOW TO BECOME A GLOBAL COMPANY?

To build its global presence in a way that minimises risk and maximises return, a company must address the following four questions:

"1. Which product line or lines should be used as the launch vehicle for globalisation ?

2. Which markets should be entered first ?

3. What would be optimal mode of market entry ?

4. How rapidly should the company expand globally?"[17]

As far as the first question is concerned, Anil Gupta and Vijay Govindarajan argue that since global expansion poses a high risk to any firm entering the global arena for the first time, it is better to select a specific product line or some product lines for the purpose of globalisation rather than globalising the entire portfolio simultaneously. Choice of the product line(s), in turn, is to be determined by the twin goals of maximising returns and minimising risk. The question of the choice of market is determined by several factors, some having to do with 'market potential' and some with 'learning potential'. Market potential refers to both current market size and growth expectations for a particular line of business. As far as learning potential is concerned, it is governed by two things: (*i*) the presence of sophisticated and demanding customers for a product who force the company to innovate continuously, and (*ii*) the pace at which technologies are evolving in the market. The timing of a firm's entry into strategic markets depends on its ability to exploit them. This ability depends upon the extent of entry barriers and the intensity of competition in the market. ***Lower entry barriers and less intensity of competition in a market are conducive to a firm's entry in that market.***

As far as the third question of mode of entry into a country is concerned, the company has to consider two questions: (*i*) to what extent will the company rely on exports versus local production within the target market ? and (*ii*) to what extent will the company exercise ownership control over those activities to be performed locally in the target market ? As far as the first question is concerned, Anil K. Gupta and Vijay

Govindrajan argue that greater reliance on local production is more appropriate under the following four conditions: (*a*) the local market is larger than the minimum efficient scale of production so that local production translates itself into scale economies while holding down tariff and transportation costs; (*b*) shipping and transportation costs to the target market are so high that they neutralise any cost advantages of production anywhere than the target market; (*c*) the need for local customisation of the product design is high; and (*d*) local content requirements are high (this is one of the major reasons why foreign auto companies rely heavily on local production in countries like India and China).

As far as the second question relating to the extent of ownership control over locally performed activities is concerned, the choice ranges from zero per cent ownership modes (such as licensing or franchising), through partial ownership modes (such as joint ventures or affiliates), to cent per cent ownership modes.

As far as the question of the speed of global expansion of a company is concerned, it depends on the availability of managerial, organisational and financial resources to a company. Faster global expansion is more appropriate under the following circumstances: (*i*) it is easy for competitors to replicate a firm's recipe for success; (*ii*) scale economies are extremely important; and (*iii*) management's capacity to manage global operations is high.

The question of globalising company's presence is intricately linked up with the question of global market opportunity. In the case of food companies like Nestle, total population of a country could be a useful indicator of global market opportunity while for companies engaged in transportation business, the geographical area could be more important. In any case, large-volume markets are likely to find more favour with the globalising companies. This is the reason why large-volume markets like China and India have been receiving increasing attention of many MNCs in recent years seeking to further globalise their operations. According to B. Bhattacharyya, "For MNCs everywhere, the writing on the wall is clear; not participating in China's economy is tantamount to not participating in the world's economy in future."[18] Several MNCs have already realised this and close to 700 companies (from GE to Cisco, Motorala to Intel, and IBM to Kodak) have put down roots in China.[19]

Turning Global Presence into Global Competitive Advantage

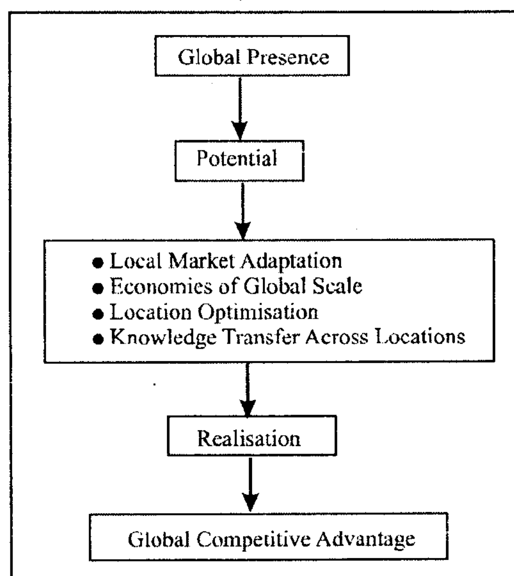
Global presence does not automatically ensure competitive advantage. Vijay Govindarajan and Anil Gupta cite the example of Pepsi Co. in this respect which boldly pursued the strategy of increasing its global presence in early 1990s targeting an increase of its international soft drink revenues by more than three times in a five year period (from $ 1.5 billion in 1990 to $ 5 billion in 1995). However, this global expansion did not translate into growth and profitability. In fact, by 1997, Pepsi was withdrawing from some major markets such as South Africa and had to face a loss of nearly $ 1 billion from its international beverage operations.[20] As correctly pointed out by Vijay Govindarajan and Anil Gupta, ***"Turning global presence into global competitive advantage requires a company to exploit the value-creation opportunities generated by global presence and to meet related challenges."*** Four most significant sources of global competitive advantage listed in Figure 19.1 are as follows :

- **Adapting to local market differences.** Being present in multiple countries means that a company must respond to different markets through local adaptation of products, services and processes. Such local adaptation can yield the following benefits to a company : (*i*) it can help the company in increasing its market share by attracting more customers; (*ii*) tailoring the product according to customers' requirements increases the 'value delivered' to those customers and thus justifies higher prices (helping the company to improve its price realisation); and (*iii*) the advantage that local competitors enjoy by way of better understanding of the needs of the local market is effectively neutralised.

- **Exploiting economies of global scale.** A primary effect of building global presence is that companies enjoy a large scale of operations resulting in larger revenues, a larger asset base and so forth. This can create competitive advantage provided the company undertakes systematic efforts to convert large scale into economies of scale. Exploiting economies of scale can result in one or more of the following benefits: (*i*) the cost of fixed costs are distributed over larger sales volumes enabling the company to bring down its per unit-cost (this benefit occurs more markedly in activities such as Research and Development, and advertising); (*ii*) as a global company concentrates its purchasing power over any specific supplier, it generally benefits from volume discounts and lower transaction costs; and (*iii*) a larger scale gives the global business the opportunity to build centres of excellence for the development of technologies and/or products.

- **Tapping the optimal locations.** Every firm has to perform a number of activities along its value chain—

Figure 19.1.



Source: Vijay Govindarajan and Anil K. Gupta, "Turning Global Presence into Global Competitive Advantage", in *Business Standard*, "Mastering Global Business", Part II, November 27, 1998, Fig. 1, p. 4.

for example, research and development, manufacturing, marketing and distribution. Tapping the optimal locations for executing each activity can result in (*i*) performance enhancement; (*ii*) cost reduction; and (*iii*) risk reduction. Vijay Govindarajan and Anil Gupta point out that Microsoft's decision to establish a corporate research laboratory in Cambridge in UK was guided by its goal of building world-class excellence in a selected activity. On the other hand, Nike's decision to manufacture athletic shoes in Asian countries like China, Vietnam and Indonesia was founded basically on cost-reduction considerations.

• **Minimising knowledge transfer.** To exploit the resource and/or market opportunities of the local environment, every subsidiary has to accumulate some unique knowledge. Some of this knowledge may be relevant across several countries and if leveraged effectively can yield benefits in the form of (*i*) faster product and process innovation; (*ii*) lower cost of innovation; and (*iii*) reduced risk of competitive pre-emption.

A CRITIQUE OF GLOBALISATION

In his book *Globalisation and its Discontents* published in 2002, former Chief Economist of the World Bank and the winner of Nobel Prize for Economics in 2001, Joseph Stiglitz has alleged that globalisation has not brought the promised economic benefits to the developing countries. The main arguments put forward by Stiglitz in support of this contention are as follows:[21]

1. The proponents of globalisation have been arguing that if developing countries are to grow and fight poverty, they must globalise their economies. However, actual experience shows that ***globalisation has been accompanied by increasing levels of poverty.*** During 1990s while total world income increased by an average of 2.5 per cent annually, the actual number of people living in poverty increased by almost 100 million.

2. ***If globalisation has not succeeded in reducing poverty, neither has it succeeded in ensuring stability.*** Crises in Asia and in Latin America have threatened the economies and the stability of all developing countries. There are fears of financial contagion spreading around the world, that the collapse of one emerging market currency will mean that others fall as well.

3. ***Globalisation and the introduction of a market economy has not helped making a transition from communism to the market*** (like Russia and East European countries). Proponents of globalisation had promised to these countries that the new economic system would bring them unprecedented prosperity. Instead what they got was unprecedented poverty. As Stiglitz has argued, for most of the people in these economies, the market economy proved even worse than what their Communist leaders had predicted.

4. ***Stiglitz has accused the Western countries of 'hypocrisy' because while these countries have pushed***

poor countries to eliminate trade barriers, they have themselves kept up their own barriers (like quotas on a multitude of goods from textiles to sugar). Thus developing countries were deprived of desperately needed export income. Moreover, while developing countries were forced to eliminate their subsidies on industrial goods, the developed countries continued to provide high levels of subsidies to agricultural goods (which are of export interest to the developing countries).

5. Even when not guilty of hypocrisy, ***the Western countries have conspired to get a disproportionate share of the benefits from international trade.*** This they have accomplished by turning the terms of trade against the developing countries. Stiglitz has argued that after the Uruguary Round trade agreement in 1995, the *net* effect of the terms of trade movements was to lower the prices received by some of the poorest countries of the world relative to what they paid for their imports. The result was that some of the poorest countries in the world were actually made worse off.

6. Western banks benefited from the loosening of capital market controls in Asia and Latin America, but those regions suffered when inflows of speculative hot money that had poured into countries suddenly reversed. The abrupt outflow of money left behind collapsed currencies and weakened banking systems.

7. As correctly pointed out by Stiglitz, ***the intellectual property rights regime as established under the Uruguay Round and being implemented by the WTO (World Trade Organisation) is heavily biased in favour of the developed countries and against the developing countries.***[22] This is due to the reason that it overwhelmingly reflects the interests and perspectives of the producers, as opposed to the users. Since a majority of patents lie with producers in the developed countries (particularly the MNCs), they are the major beneficiaries of the new international economic regime. The most serious aspect of this regime is the likely impact on drug prices. Since most of the drug patents are with MNCs, the drug price hikes likely to be announced by them in coming years could put many drugs out of reach of the poor people in developing countries. This is likely to throw the entire health systems in many developing countries in jeopardy.

8. According to Stiglitz, not only in trade liberalisation but in every other aspect of globalisation even seemingly well-intentional efforts have often misfired. For instance, if projects (whether in agriculture or infrastructure) recommended by the Western economists and financed by World Bank or other international institutions fail, the developing countries are still forced to repay the loans. This causes immense burden on the poor people of these countries.

9. The conditions imposed by international lenders on the recipients of aid (known as ***'conditionalities'***) involve substantial interference in the decision making process of the developing countries and thus ***undermine*** their ***national sovereignty.***

Thus benefits of globalisation have been much less than what its advocates claim, the price paid has been higher, as the environment has been destroyed, as political processors have been corrupted, and as the rapid pace of change has not allowed countries time for cultural adaptation. Moreover, as emphasized by Stiglitz, "The crises that have brought in their wake massive unemployment have, in turn, been followed by longer-term problems of social dissolution—from urban violence in Latin America to ethnic conflicts in other parts of the world, such as Indonesia."[23]

GLOBALISATION IN INDIA

Globalisation in India is generally taken to mean integrating the economy of the country with the world economy. This, in turn, implies opening up the economy to foreign direct investment by providing facilities to foreign companies to invest in different fields of economic activity in India; removing constraints and obstacles to the entry of MNCs in India (through dilutions and ultimate scrapping of restrictive laws like FERA); allowing Indian companies to enter into foreign collaborations in India and also encouraging them to set up joint ventures abroad; carrying out massive import liberalisation programmes by switching over from quantitative restrictions to tariffs in the first place (so that there is more 'transparency' in import policy), and then bringing down the level of import duties considerably; and instead of a plethora of export incentives (like duty drawbacks, cash compensatory support, replenishment licences and other fiscal incentives etc.) opting for exchange rate adjustments for promoting exports. As our discussion in the chapters on 'Industrial Policy', 'Industries (Development and Regulation) Act, 1951 and Industrial Licensing', 'Export Import Policy and Trade Liberalisation', 'FERA and FEMA' and 'Foreign Investment, Technology and MNCs' will amply bring out, seeds of this globalisation process were sown in the early 1980s itself as many concessions were granted to foreign capital, MNCs were allowed to enter a number of crucial sectors to which their entry was previously

restricted or banned, provisions of FERA were not strictly enforced, import liberalisation process was accelerated considerably, and downward adjustment in the exchange rate of the rupee was resorted to. However, ***the real thrust to the globalisation process was provided by the new economic policy introduced by the Government of India in July 1991 at the behest of the IMF and the World Bank.*** In all recent discussion, therefore, globalisation has been identified with the policy reforms of 1991 and the subsequent extension of these reforms carried out in later years.

The 'Push' Towards Globalisation

The period after 1980-81 in India was marked by severe balance of payments difficulties. The second oil shock in 1979-80 which was the result of a steep hike in oil prices by OPEC countries (from around $ 13.00 per barrel in late 1978 to around $ 35.00 per barrel in 1979) pushed up India's import bill substantially while exports lagged considerably behind. Thus trade deficit rose to astronomical heights. During Seventh Plan private remittances also showed a tendency of flattening out. As a result, net invisibles could finance only 24 per cent of trade deficit in the Seventh Plan. The problems were compounded by the Gulf War in 1990-91. Trade deficit in this year soared to Rs. 16,934 crore and invisibles also recorded negative earnings. As a result, current account deficit was as large as Rs. 17,369 crore in 1990-91. The problem got further accentuated by India's increased reliance on high cost external commercial borrowings and non-resident deposits all through the 1980s as the flow of concessional assistance was considerably less than the requirements. Much of this borrowing on commercial terms was in the form of relatively short-term and potentially volatile instruments increasing the vulnerability of Indian economy to changes in investors' confidence and expectations. With the downgrading of India's credit rating by some international agencies consequent upon the large deficit in India's balance of payments in 1990-91 and the political uncertainties at home, the investors' confidence in the Indian economy was shaken suddenly and there was a substantial capital outflight. For example, over the period October 1990 to the second quarter of 1991, over $ 300 million per month were withdrawn from the NRI deposits. Despite drawing $ 1.8 billion from the Contingency Compensatory Financing Facility (CCFF) in January 1991, adopting import compression measures, and pledging gold abroad, the crisis could not be stemmed. Foreign exchange reserves dwindled to $ 1.1 billion in June 1991—less than sufficient for two weeks of import requirements. Default on debt servicing appeared imminent and the Government of India was pushed to the wall. Default could be avoided only if credit was made available from the IMF or the World Bank. Assistance was indeed made available by these institutions but on their own terms and conditions. These terms and conditions entailed the adoption of a 'stabilisation and structural adjustment programme' by India.

The stabilisation and structural adjustment programme of the IMF-World Bank had the following three components: "(a) stabilisation which basically implies cutting down fiscal deficit and the rate of growth of money supply, (b) domestic liberalisation which consists of relaxing restrictions on production, investment, prices and increasing the role of market signals in guiding resource allocation, and (c) external sector liberalisation or relaxing restrictions on international flows of goods, services, technology and capital."[24] ***Globalisation is identified with (c) i.e. external sector liberalisation.*** However, it needs to be emphasized that success on (*a*) and (*b*) fronts is crucial for the success of (*c*). For instance, stabilisation in the sense of cutting down fiscal deficit and the rate of growth of money supply are essential for keeping inflation and balance of payments under control as both these problems arise from a mismatch between aggregate demand and aggregate supply. (Foreign investment is attracted only when inflation and balance of payments are under control). Domestic liberalisation involving relaxation of restrictions on production and investment leads not only to a reduction in bureaucratic interference and controls which have since long outlived their utility but also sends 'definite positive signals' to the foreign investors about the 'genuineness' of the reform process.

The above discussion shows that the conditions that prevailed in 1990 and 1991 'pushed' India into adopting the structural adjustment programme of the IMF and World Bank. Since globalisation is a part of the structural adjustment programme, it is rightly said that it were the desperate conditions of 1990 and 1991 that 'pushed' India towards globalisation.

STEPS TOWARDS GLOBALISATION

The main policy measures initiated towards globalisation by the Government of India can be discussed under the following headings:

Exchange Rate Adjustment and Rupee Convertibility

The most important measure of integrating the economy of a country with the global economy is to make its currency fully convertible, i.e., allow it to determine its own exchange rate in the international market without official intervention. This measure has to be accompanied by the lifting of exchange control measures in a phased manner. As a first step towards this measure, the IMF insisted on devaluation of the Indian. Accordingly ***the Government of India make a two-step downward adjustment of 18-19 per cent in the exchange rate of the rupee on July 1, and 3, 1991.*** Therefore, the first important condition laid down by the IMF for the grant of assistance was met.

In the subsequent years, the Government of India has progressively moved forward towards full convertibility. As we shall discuss in the chapter on 'Export-Import Policy and Trade Liberalisation' the 1992-93 Budget introduced a dual exchange rate system implying partial convertibility of rupee. The 1993-94 Budget introduced full convertibility of the rupee on trade account and switched over to a unified exchange rate system. ***India achieved full convertibility on current account on August 19, 1994.*** Current account convertibility has been defined as the freedom to buy or sell foreign exchange for the following international transactions: (*i*) all payments due in connection with foreign trade, current business, including services, and normal short-term banking and credit facilities; (*ii*) payments due as interest on loans and as net income from other investments; (*iii*) payments of moderate amount of amortization of loans or for depreciation of direct investments; and (*iv*) moderate remittances for family living expenses. The Reserve Bank accepted obligations under Article VIII of the IMF, under which India is committed to forsake the use of exchange restrictions on current international transactions as an instrument in managing the balance of payments. Many other relaxations of restrictions were announced in subsequent years.

Import Liberalisation

In its Report *India : Strategy for Trade Reform* released in 1990, the World Bank had advocated redesigning of the import policy so that there is only one negative (restricted) list and imports of all items not explicitly on the restricted list are allowed, lowering of import tariffs on all goods, and freer entry to capital goods, intermediate goods, raw materials and consumer goods into the Indian economy. In line with these proposals, the 1992-97 export-import policy allowed the free import of all items including capital goods, except a negative list. The supplementary trade policy announced on August 13, 1991 decanalised the import of 20 items. In addition, import duties on a wide range of commodities were drastically cut down. For instance, customs duties on 35 items were slashed from 255 per cent ad valorem to 150 per cent ad valorem on February 9, 1993. This was followed by substantial reduction of import duties in the 1993-94 Budget. For example, the Budget reduced the import duty on a number of capital goods by 20 to 30 percentage points. Duties on a host of other commodities were also reduced. In fact, the maximum rate of duty on all goods was reduced from 110 per cent to 85 per cent except for a few items including passenger luggage and alcoholic beverages. The maximum rate of import duty has been reduced in successive Budgets in stages. The peak import duty on non-agricultural goods is now only 10 per cent.

In addition to the phased reduction of import duties, India, as a member of World Trade Organisation (WTO), had also committed itself to the phasing out of quantitative restrictions over a six year period beginning 1997. This period was further reduced following the ruling of the Disputes Settlement Body of the WTO against India on an appeal made by the USA. In terms of the agreement arrived at with USA, the quantitative restrictions have now been totally removed. Moreover, as a part of the Agreement on Trade Related Intellectual Property Rights (TRIPs), the Patents (Amendment) Act, 1999 was passed in March 1999 to provide for Exclusive Marketing Rights (EMRs). This was followed by the adoption of Patents (Amendment) Act, 2002, in May 2002 and Patents (Amendment) Act, 2005.

The stock argument in favour of import liberalisation is that competition from imports would improve efficiency, quality and technology besides making international quality capital goods and inputs available to our export industries (hence increasing their competitive strength in the international markets).

Opening up to Foreign Capital

In a bid to attract foreign capital and integrate the Indian economy with the global economy, the Government of India has thrown open the doors to foreign investors. Various incentives and facilities have been offered to the foreign investors and non-resident Indians in the new economic policy. In 1991, the government announced a specified list of high technology and high-investment priority industries (listed in Annexure III) wherein

automatic permission was granted for direct foreign investment upto 51 per cent foreign equity. This limit was raised from 51 per cent to 74 per cent and subsequently to 100 per cent for many of these industries. Presently FDI is permitted upto 100 per cent on the automatic route in most sectors subject to sectoral rules/regulations, applicable. FDI is prohibited only in the following sectors: (1) retail trading (except single brand product retailing), (2) atomic energy, (3) lottery business, and (4) gambling and betting.

Many other measures have been announced from time to time. For instance, foreign companies have been allowed to use their trademarks in India and carry on any activity of a trading, commercial or industrial nature; repatriation of profits by foreign companies has been allowed; foreign companies (other than banking companies) wanting to borrow money or accept deposits are not now required to obtain permission from the Reserve Bank; foreign companies can now deal in immovable property in India; restrictions on transfers of shares by a non-resident to another non-resident have been removed; disinvestment of equity by foreign investors no longer needs to be at prices determined by the Reserve Bank (disinvestment has now been allowed at market rates on stock exchanges with permission to repatriate the proceeds of such disinvestment); 100 per cent foreign equity participation has been allowed for setting up power plants in the country (this allows free repatriation of profits and other incentives); NRIs and overseas corporate bodies (OCBs) predominantly owned by them have been allowed to invest upto 100 per cent equity in high priority industries with repatriability of capital and income; NRI investment upto 100 per cent of equity has been allowed in export houses, trading houses, star trading houses, hospitals, EOUs, sick industries, hotels etc.; reputed Foreign Institutional Investors (FIIs) have been allowed to invest in Indian capital market subject to registration with the Securities and Exchange Board of India and approval of RBI; foreign direct investment under the automatic route has been permitted up to 100 per cent for all manufacturing activities (with certain exceptions) in Special Economic Zones (SEZs); 100 per cent foreign direct investment has been allowed in telecom sector for certain activities; 100 per cent foreign direct investment has been allowed in pharma sector, airports, hotel and tourism industry, township development, courier services and Mass Rapid Transport System (MRTS), FDI limit in private airlines has been liked to 49 per cent; FDI limit in private sector banks has been raised to 74 per cent, etc.

EFFECTS OF GLOBALISATION

Effects on the External Sector

The process of globalisation initiated in 1991 and the far reaching changes in industrial and other policies have led to considerable changes on the external sector front. The Finance Minister in his Budget Speeches in 1994 and 1995 claimed the following achievements on the external front: (1) Our foreign currency reserves which had fallen to barely one billion dollars in June 1991 rose substantially to over 20 billion dollars on March 10, 1995; (2) Exporters are responding well to sweeping reforms of exchange rate and trade policies. This would be clear from the fact that as against a fall in the dollar value of exports by 1.5 per cent in 1991-92, the exports grew by over 17 per cent in the first 10 months of 1994-95. This follows a 20 per cent increase in 1993-94. Though imports also grew in line with the revival of the economy yet the balance of payments situation is comfortable; (3) The fears expressed in some quarters that our trade policy would generate a disruptive flood of imports and weaken our economy have been shown to be completely unfounded. Liberalisation and openness have actually increased our self-reliance. Exports now finance over 90 per cent of imports, compared to only 60 per cent in the latter half of the 1980s; (4) The current account deficit was over 3 per cent of GDP in 1990-91. It is expected to be less than 0.5 per cent in 1994-95.[25] (5) At the time of crisis, our external debt was rising at the rate of $ 8 billion a year. In 1993-94, the increase in external debt was reduced to leas than $ 1 billion. In the first half of 1994-95, our external debt stock actually declined by almost $ 300 million; (6) Contrary to what many feared, the exchange rate for the rupee has remained remarkably steady despite the introduction of full convertibility first on trade account and then on current account. Foreign exchange is flowing through legal channels in ample quantities instead of through illegal (*hawala*) channels as earlier; and (7) International confidence in India has been restored. As a result, foreign direct and portfolio investment has increased rapidly in the last 3-4 years.[26]

However, in 1995-96, the current account deficit, as a proportion of GDP, rose to 1.7 per cent from the level of 1.0 per cent in 1994-95. Yet, as noted by the *Economic Survey* 1996-97, there was no cause of alarm as the increased deficit was easily financed by a higher level of capital inflows and a reduction in foreign exchange reserves of US $ 2.9 billion. Despite the reserve drawdown, the level of foreign currency assets at the end of 1995-96 was $ 17.0 billion, which was quite comfortable. During 1996-97, the current account

deficit was 1.2 per cent of GDP. This was significantly higher than the average accumulation of $ 3.4 billion during 1991-92 to 1996-97. The balance of payments position in 1997-98 and 1998-99 also remained comfortable as the surplus in the capital account exceeded the deficit in the current account by a substantial margin, resulting in large accretion to foreign exchange reserves amounting to $ 3.9 billion in 1997-98 and $ 3.8 billion in 1998-99. The situation improved further in 1999-2000 and subsequent years. For example, reserve accumulation was $ 6.14 billion in 1999-2000 and $ 5.84 billion in 2000-01. Things were still better in 2001-02, 2002-03 and 2003-04 as there was a current account surplus in these years because of strong positive earnings from invisibles (it was after a long gap of 24 years that a current account surplus was recorded, the last current account surplus having been registered in 1977-78). There was a substantial surplus on capital account also in these years. As a result of these two tendencies—surplus on current account and substantial inflows of capital—there was a large accretion to foreign exchange reserves of $ 11.76 billion in 2001-02, $ 16.98 billion in 2002-03 and $ 31.42 billion in 2003-04. After registering surplus for three consecutive years, the current account again saw a deficit in 2004-05. This deficit was of $ 2.5 billion. However, there was a substantial surplus of $ 28.6 billion in the capital account with the result that there was an accretion of $ 26.1 billion to foreign exchange reserves in 2004-05. The current account deficit rose to $ 9.2 billion in 2005-06 while surplus on capital acount was $ 24.2 billion. As a result, accretion to foreign exchange reserves in this year stood at $ 15 billion.[27] As a result of substantial accretion to foreign exchange reserves for most of the post-reform period, the stock of foreign exchange reserves touched the level of $ 240 billion in September 2007 whereas it was only $ 1.1 billion to June 1991.

Effect on the Indian Enterprises

The process of globalisation in India had led to an 'unequal competition'—a competition between 'giant MNCs' and 'dwarf Indian enterprises.' Even the large Indian enterprises are just pygmies compared to the multinational corporations and while some of them have already been gobbled up by the latter, some others are awaiting their turn with bated breath. As once noted by an MP from West Bengal, the globalisation of the Indian economy is like integrating a mouse into a herd of elephants.[28]

In the early euphoria of liberalisation, the private sector welcomed the measures of the government but it soon came to realise that opening up the Indian economy to foreign competition meant more and cheaper imports, more foreign investment, opportunities to the MNCs to raid and takeover their enterprises, and worse, their inability to meet the challenge from MNCs due to their weak economic strength *vis-a-vis* the MNCs. The first serious omens of discontent appeared when several top industrialists met under the initiative of Rahul Bajaj (the owner of the scooter manufacturing giant Bajaj Auto) in 1993 in Mumbai to voice their concern at the hasty exposure of Indian enterprises to the stormy gales of foreign competition. This particular group of businessmen came to be dubbed as the 'Bombay Club'. Even the Confederation of Indian Industry (CII) which had all along been supportive of MNC initiatives started feeling uneasy. Its Director General, Tarun Dass, sharply attacked the behaviour of foreign multinationals in India, particularly referring to their 'cowboy' approach toward their local partners. Addressing a CII national conference, EID Parry's managing director M.V. Subbiah complained, "The multinationals have a strong financial power. They are buying Indian brands and gradually killing them. There should be some sort of regulatory mechanism to prevent this. The idea of inviting multinationals into India is to promote competition and not to build up monopolies by killing the Indian brands." Another noted industrialist S. K. Birla argued that "Multinationals should not be allowed unfettered freedom in India. If the multinationals are allowed to hold a majority stake in Indian joint ventures in a unfettered way, Indians would be second class citizens in their own country." Assocham president H. Somany stated, "We would like to caution (against) the predatory nature of foreign capital, sometimes manifesting in the form of hostile takeovers."[29]

In the new globalisation scenario that has emerged in the post-1991 reform phase, the Indian businessmen are thus facing unequal competition from MNCs. According to Baldev Raj Nayyar, this unequal competition stems from the following reasons:

1. As already pointed out, the Indian enterprises suffer from 'size disadvantages' as they are just minuscules as compared to the MNCs.

2. The Indian corporate sector for four decades prior to 1991 operated in a protectionist environment. The quantitative restrictions and steep customs duties ensured a captive market. In the absence of any fear of competition, the Indian firms became accustomed to producing poor quality goods as everything was bound to sell. The industrial licensing policy of the government, in a bid to prevent the growth of monopolies, resorted to fragmentation of capacity among many producers. This led to a diversification and

branching off into unrelated fields by business houses as they were interested in capturing licences to corner the market. Thus the resources of the business houses were spread thinly over a number of products and markets instead of intensive development of select industries. "The result was an insufficient and flabby industrial structure of agglomerative firms under family control, with fragmented capacities and without economies of scale, largely stagnant technology, dependent on the State for finance and protected market, hemmed in by the straitjacket of controls in literally every aspect of the economy, with little experience of real competition, and with a vested interest in an economy of scarcity and shortages which the system of controls had provided."[30] How could such a sector be expected to compete with MNCs ?

3. The cost of capital for Indian business is much higher than MNCs. This is due to the reason that real interest rates within the country have been much higher than those prevailing outside India.

4. Because of the immense financial strength of MNCs, they are not only in a position to bear losses in any line of business for a considerably more time than the Indian capitalists, they have enough 'muscle power' to force out the Indian partners from joint ventures and grab control of their companies. In fact, they can just buy out any Indian firm they like.

5. Indian firms continue to suffer from handicaps developed under the earlier regime of controls. For example, restructuring and downsizing of Indian companies is not easy as labour laws do not allow easy retrenchment of labour. As against this, MNCs start their new enterprises with modern technology and reduced requirement of labour.

6. High, multiple and cascading indirect taxes—especially at the local level, where they are not applicable to foreign imports—result in making Indian goods uncompetitive. FICCI president K.K. Modi called this aspect the 'subsidisation of imports'. In addition, Nayar points out that the tariff structure has at times contained some serious anomalies, such as when finished goods attract lower tariffs than raw materials and components. Then, again, State has allowed imports from MNCs in areas that are reserved for the small-scale sector whereas Indian business is not allowed to produce in those areas. "From the perspective of domestic manufacturers", concludes Nayar, "the State has thus not been sufficiently vigilant about their interests, for it has allowed profit margins of domestic firms to be squeezed by cheaper imports."[31]

7. In some areas, the State has pursued policies that have clearly discriminated in favour of MNCs. For example, in the power sector the State has offered counter-guarantees only to MNCs for fast-track projects without providing similar concessions to Indian firms. Then, the taxation of capital gains has favoured foreign firms with far lower rates, which could further be avoided totally if foreign firms come through Mauritius. Not only this, MNCs are allowed 100 per cent subsidiaries whereas the takeover code allows only restricted share buy back options to the Indian promoters.

On account of all these reasons, ***the process of globalisation unleashed in 1991 has 'created' a new world—a world in which not only there has been an inflow of substantial foreign capital, but the domestic corporate sector for the first time saw itself as the 'target' rather than the 'beneficiary' of the heightened activities of foreign investors.*** The swiftness, vigour and aggressiveness with which the foreign investors sought to penetrate and capture the domestic market has caused serious worry to the Indian corporate sector. Particularly, in the case of joint ventures, the MNCs have shown alarming speed in pushing over their Indian partners and gaining full control on the enterprise. The MNC activity has fuelled the rise of the East India Company syndrome described in Box 19.1.

BOX 19.1. The East India Company Syndrome

The East India Company syndrome refers to the fear that foreigners are likely, if given an opening, to take over control of a company, the economy or the country. The essentials of the original process on which the syndrome has been erected are clear : a foreign multinational from the developed world arrives at the shores of an underdeveloped country to trade but, with the backing of the power of the home country (economic, political and military), is able to extract extra-territorial privilege, sets up trading posts and recruits local collaborators to advance its interests, expands into a monopoly, gradually acquires political and military functions, finds a traitor or a set of traitors who are ready to betray the local ruler, leading to the defeat of the latter while an apathetic elite and populace looks on, with the multinational ending up in establishing an empire that exploits the population for the next couple of centuries, and all this is supposed to have been accomplished in a mythic fit of absent-mindedness.

Source: Baldev Raj Nayar, *Globalization and Nationalism* (New Delhi: Sage Publications, 2001), Note 3, p. 185.

Nayar points out three strategies adopted by the MNCs to penetrate the Indian economy through FDI (foreign direct investment)[32]. ***One,*** some foreign investors have bought off existing local brands alongwith their

branded products with the aim of replacing such products with their own internationally known products, eliminating in the process the possibility of competition from the local products. ***Two***, some foreign investors initially opted for joint ventures with Indian partners to gain easy foothold in the domestic industry but, once having consolidated their position, reduced the Indian partner to a subordinate position or simply ousted him. Thus many Indian businessmen felt that MNCs simply use them as a 'door mat' for entry and spread risk at the beginning only to be dumped later. ***Three***, some foreign investors, even as they started out with local partners in a joint venture, then went on to set up parallel 100 per cent subsidiaries of their own in the same field, which were then favoured with greater resources and more modern technology, rendering the joint venture uncompetitive and useless.

Many cases can be cited to illustrate the use of the above strategies by MNCs. For instance, Coca-Cola bought out all the popular Parle brands (like Thums up, Limca etc.) belonging to Ramesh Chauhan for some $ 40 million in 1993. To many, this was a meek surrender by Ramesh Chauhan who failed to adequately appreciate the resilience of the house he had built up over the years. Perhaps the predictions appearing in the financial press that Coke would run over Parle's brands frightened Chauhan into throwing in the towel a bit too early. In any case, up against competition from two Cola giants, Coca-Cola and Pepsi, Chauhan thought he had no chance of survival. The questions that arise at the present juncture are: did the country gain in terms of technology ? Did the country benefit in any way in terms of competition ? Did the buy-out create more choices for Indian consumers ? The answer to all these questions is a big 'No'. What actually happened was that a foreign multinational company had extinguished a local company. Another important example is that of the FMCG giant Hindustan Lever Limited (HLL) which has been on a buying spree since 1992. It acquired Kothari Foods in 1992, Dollops ice cream from Cadbury and Kissan from the UB group in 1993, Milkfood and Lakme in 1995, and Pond's (India) in 1998. In 1993, HLL merged Brooke Bond and Lipton (BBLIL). This year also saw the merger of Tata's TOMCO with HLL. Through these swift moves at acquisitions, mergers and amalgamations, HLL climbed rapidly to the top of the corporate rankings and it had the highest market capitalisation in September 1999. Some of these mergers and acquisitions were initially in the form of 'alliances' and 'joint ventures'. For instance, HLL had initially entered into an alliance with Lakme in 1995 when a 50:50 joint venture called Lakme-Lever was set up. However, in February 1998, Lakme sold its stake in the joint venture and all its brands to HLL for a price of Rs. 2 billion. Similar has been the fate of Pond's (India) as well. In fact, the gobbling up of several local companies like Kothari General Foods, Dollops, Kissan, Kwality, Milk Food, TOMCO (the 75-year old Tata Company which was at one time a close second to HLL), Lakme, Pond's (India) etc, by HLL is a clear example of the 'hunger' of MNCs to devour domestic enterprise and steer clear of any existing or potential market competition.

The way how domestic enterprise is 'used' by MNCs to gain foothold in the country only to be dumped later is fully illustrated by the strategy followed by foreign automobile manufacturers in India. Some of the important joint ventures that were set up in recent years in the automobile industry were those between Daewoo Motors and DCM, between Honda and Siel, between Ford and Mahindra, and between General Motors and Hindustan Motors. The joint venture between Daewoo Motors and DCM was born in 1994 with the former holding 51 per cent and the latter 49 per cent stake. By 1997, Daewoo Motors had increased its stake to 94.5 per cent while DCM's stake was reduced to a meagre 5.5 per cent. 'Mahindra Ford' was initially a 50 : 50 joint venture between Ford Motor Company and Mahindra & Mahindra. The equity pattern in the company has now changed following FIPB clearance which has allowed Ford to increase its stake to 92.5 per cent. Naturally Mahindra & Mahindra have been marginalised with their share being reduced to just 7.5 per cent. The 'Honda Siel Cars India' was initially set up as a joint venture between Honda Motor company of Japan and Siddharth Shriram Group of India. Although it started off as a 60:40 joint venture, Honda raised its stake to 90 per cent in 1998 pushing down Siel's holding to just 10 per cent. The GM-HM joint venture between General Motors and C.K. Birla group's Hindustan Motors was originally a 50 : 50 partnership. However, in early February 1999, this turned 100 per cent subsidiary of General Motors with Hindustan Motors selling its entire 50 per cent stake to the former. This discussion shows that in all cases the story has been more or less the same. In all the cases, the MNC partner brought technology, money muscle and brand equity while the Indian partner brought government and market knowledge, distribution strength and sometimes assembling facilities. The latter helped the MNC to achieve its objective. For instance, Ford could never have been able to roll out the Escort model in "10 months flat" without support from Mahindra & Mahindra and the use of its Nasik facility.[33] However, once having got a clue to the working of the Indian market, the MNC had no use for the Indian partner and thus conveniently dumped him. This has happened in all the car joint ventures mentioned here—clear cases of MNCs gobbling up the Indian enterprises.

Foreign shareholders have increased their holding in Indian companies considerably. They now own almost a third of corporate India with their holding in Indian companies being as high as 30 per cent as on September 30, 2005. If the focus is only on the private sector, foreign stakes in the Indian corporate sector go up substantially to 38.93 per cent. In the public sector — listed public sector undertakings and banks — foreign holdings are 10.83 per cent. Of the 2,457 companies included in the study, foreign holdings is more than 50 per cent in 164 companies (these include HDFC, Satyam Computers, ICICI Bank, Infosys Technologies , Essar Oil, Zee Telefilms, etc.), between 25 per cent and 49.95 per cent in 180 companies, between 10 and 24.95 per cent in 334 companies, and between 5 and 9.90 per cent in 240 companies.[34]

NOTES

1. Deepak Nayyar, "Globalisation: What Does it Mean for Development?" in Bibek Debroy (ed.) *Challenges of Globalisation* (New Delhi, Konark Publishers Private Ltd., 1998), p. 15.
2. Kavaljit Singh, *A Citizen's Guide to the Globalisation of Finance* (Delhi: Madhyam Books, 1998), pp. 3-4.
3. World Bank, *The Little Data Book 2003* (Washington, 2003), p. 8.
4. Deepak Nayyar, *op. cit.,* p. 18.
5. Michael P. Todaro and Stephen C. Smith, *Economic Development* (Pearson Education Asia, Eighth edition, 2003), p. 636.
6. To appreciate the magnitude of these figures, just consider the fact that 1 trillion = 1,000 billion and 1 billion = 1,000 million. Thus the combined sales of 200 top corporations of the world in 1998 was $ 7100,000,000,000.
7. Kavaljit Singh, *Taming Global Financial Flows* (Delhi, Madyam Books, 2000), p.1.
8. Vijay Govindrajan and Anil Gupta, "Setting a Course for a New Global Landscape", in *Business Standard,* "Mastering Global Business", Part I, November 20, 1998, p.3.
9. *Ibid.,* p. 3.
10. Deepak Nayyar, *op. cit.,* p. 20.
11. Kavaljit Singh (2000), *op.cit.* pp. 9-10.
12. *Ibid.,* p. 11.
13. Deepak Nayyar, *op. cit.,* p. 21.
14. This point is discussed in detail in the chapter "WTO and India" under the section 'WTO-Trespassing the Sovereignty of Nation States.'
15. For excellent analysis of the Mexican crisis and the Southeast Asian crisis, please see Kavaljit (1998), especially Part II "Recent Financial Crisis in Developing Countries: Experiences and Lessons."
16. Deepak Nayyar, *op.cit..,* p. 22.
17. Anil Gupta and Vijay Govindarajan, "How to Build a Global Presence", in *Business Standard* "Mastering Global Business", Part I, November 20, 1998, p. 6.
18. Quoted by Ashish Gupta, "Sleeping Tiger—Leaping Dragon". *Business Today,* July 6, 2001, p. 59.
19. *Ibid.,* p. 59.
20. Vijay Govindarajan and Anil K. Gupta, "Turning Global Presence into Global Competitive Advantage", in *Business Standard,* "Mastering Global Business", Part II, November 27, 1998, p. 4.
21. Joseph Stiglitz, *Globalisation and its Discontents* (Allen Lane—The Penguin Press, 2002), See Chapter 1 "The Promise of Global Institutions."
22. For a discussion of this point, please refer to Chapter 20 'WTO and India' of the present book.
23. Stiglitz, *op.cit.,* p. 8.
24. Alok Ray, "External Sector Liberalisation in India", *Economic and Political Weekly,* October 2, 1993, p. 2161.
25. The actual current account deficit in 1994-95, however, turned out to be 1.0 per cent of GDP.
26. "Union Budget 1995-96" Speech of the Finance Minister, *The Economic Times,* March 16, 1995. Also see the Budget Speech, 1994-95. *The Economic Times,* March 1,1994. Data on foreign investment are from *Economic Survey,* 1995-96, Table 6.4, p. 97.
27. Government of India, *Economic Survey* 2006-07 (New Delhi, 2007), Table 6.2, p. 108.
28. Baldev Raj Nayar, *Globalization and Nationalism* (New Delhi: Sage Publications, 2001), p. 163.
29. *Ibid.,* p. 169.
30. *Ibid.,* p. 164.
31. *Ibid.,* p. 167.
32. *Ibid.,* p. 173.
33. Nandini Sen Gupta, "Changing Courses", *The Economic Times,* February 14, 1999, p. 7. Also see *Business Standard,* February 3, 1999, p. 1.
34. *Business Standard,* December 21, 2005, p. 1.

CHAPTER

20 INTERNATIONAL INSTITUTIONS—THE IMF AND WORLD BANK

The International Monetary Fund
• Objectives of the Fund
Working of the IMF
• Quota and Par Values • Special Drawing Rights • Assistance from IMF • Conditionalities and Economic Stabilization Programmes
World Bank
• Functions of World Bank • World Bank Activities • Structural Adjustment • Lending and Conditionalities
Overlapping Roles of IMF and World Bank
Conditionalities and Washington Consensus
A Critical Evaluation of IMF and World Bank

The period between the First and Second World Wars was marked by extreme dislocation of international trade, trade strifes, various kinds of discrimination and trade restrictions erected behind high protectionist walls, and a total disruption of the world's currency system with no generally accepted exchange rate regime. Country after country resorted to competitive devaluation as governments tried desperately to stimulate aggregate demand and reduce unemployment. The total dislocation of the international monetary system was accompanied by the massive destruction of life and property that followed the outbreak of the Second World War. As a result of World War, most of the economies of Europe were badly shattered. The major economists of the 1940s, particularly John Maynard Keynes, were greatly affected by the economic crisis that engulfed the world and sought to reconstruct the world economy after the end of the Second World War. Thus, under the intellectual leadership of Keynes, 44 nations of the world gathered in 1944 at Bretton Woods, New Hampshire, where it was agreed to organise the world economy around three cornerstones: the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (IBRD), also known as the World Bank, and the International Trade Organisation (ITO). Of these three institutions, while the first two were set up, the third could not see the light of the day due to its non-approval by the United States of America. In place of ITO, what came into being was the General Agreement on Tariffs and Trade (GATT), discussed in the next chapter. While the objective of the IMF was to ensure (and maintain) the stability of exchange rates, the objective of the World Bank was to assist in the reconstruction of the war-torn economies of Europe. The participating nations of the Bretton Woods conference also recognised the fact that world stability and peace would only be ensured if the vast majority of people living in many poor countries around the globe could be provided a reasonable standard of living. Therefore, alongwith providing assistance in the reconstruction of war-torn economies of Europe, the World Bank was also entrusted the task of providing assistance to the development processes in the underdeveloped countries. Hence the name of the Bank was kept as 'International Bank for Reconstruction and Development'. Over the period, the name 'World Bank' has gained more currency.

The 44 nations attending the Bretton Woods conference signed the Articles of Agreement setting up the