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# Introduction: Macroeconomic Crisis and Radical Reforms

India entered the last decade of the twentieth century with a severe macroeconomic and balance of payments crisis. The consolidated gross fiscal deficit of its central and state governments in fiscal year 1990–91 was as high as 9.4 percent of GDP, and the current account deficit was 3.1 percent of GDP.<sup>1</sup> The inflation rate was more than 10 percent, and by the summer of 1991, foreign exchange reserves were below two weeks' worth of imports. The debt-led growth of the 1980s came to a sudden and tumultuous halt: industrial growth was a paltry 0.7 percent, and GDP growth was 1.3 percent in the crisis year 1991–92 (Ministry of Finance, Government of India, *Economic Survey*, 2002, tables 0.1 and 1.6).

The crisis, coming at the same time as the collapse of the Soviet Union, India's ally and implicit economic role model, appears to have been a cathartic moment for Indian economic policymakers. Prime Minister Narasimha Rao's administration—prompted by the spectacular failure of the effort to maintain both high growth and an inward-oriented centrally planned industrialization strategy, as well as by the obvious growth of China since its opening to the world economy and of India's other

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1. S. Acharya, "India's Medium-Term Growth Prospects," *Economic and Political Weekly*, July 13, 2002, 2897–906; the figures in the text are taken from tables 5 and 8. The figures quoted in Acharya's essay might differ from the figures cited in subsequent discussion from publications of the Government of India, the International Monetary Fund, and the World Bank. The differences arise from differences in the definition of a fiscal deficit, as well as from revisions in the data, particularly of the GDP series, which was rebased to 1993–94 prices from the earlier series with 1980–81 prices.

outward-oriented East Asian neighbors—launched systemic reforms across the board covering foreign trade and investment, exchange rate management, and industrial policies, as well as the role of the public sector in production and distribution. The process of reforms faltered with political complications in the middle and late 1990s, but India's move toward international integration resumed after a more cohesive coalition with a larger majority came to power in 1999.<sup>2</sup>

This book documents the background and explores the consequences of India's shift in 1991 from an inward-oriented, state-led development strategy to a policy of active reintegration with the world economy. The remainder of this chapter provides general background on India's economy, polity, and society. Chapter 2 traces the evolution of India's participation in world trade for commodities, services, capital, and technology and evaluates the achievements of economic policy reforms since July 1991. India's inward-looking development strategy did not preclude its participation in international economic negotiations, and it has frequently acted as a leading representative in voicing developing-country concerns in international forums.

Chapter 3 focuses on this participation, in particular on India's role in the General Agreement on Tariffs and Trade (and its successor, the World Trade Organization). Chapters 4 and 5 turn to the reform agenda. Chapter 4 addresses the domestic constraints on India's greater integration with the global economy in a broad sense. Chapter 5 is devoted to the tasks ahead in pursuing the integration process and in achieving rapid and sustained growth.

## **Polity and Society**

India has the physical, cultural, and economic dimensions of a medium-sized continent. It is the second most populous country in the world (after only China), with an estimated population of 1.027 billion in 2000. Only 6 countries have land areas exceeding India's 2.97 million square kilometers, and India is endowed with a very high proportion of arable land in total land (56 percent). India's climate ranges from tropical in the South to temperate in the Himalayan foothills to a desert climate in parts of the North.

The nation is culturally diverse. About 70 percent of India's population is Hindus. With 12 percent of its population being Muslims, India is the fourth largest Muslim country in the world, after only Indonesia, Pakistan, and Bangladesh. The Jewish and Christian communities of Kerala

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2. After the defeat of the Congress Party in the 1996 elections, two unstable coalitions, one with Deve Gowda as prime minister and another with Inder Kumar Gujral as prime minister, held power for brief periods.

are ancient. Although the date of their arrival is uncertain, legend has it that Jews arrived and settled around Cochin during the period of King Solomon and that Saint Thomas the Apostle brought Christianity to India. Zoroastrians (Parsis) came to India after the Muslim conquest of Iran in the eighth century. There are 15 major language groups in the country.

The overall dimensions of the country's economy are equally imposing, though per capita income is low. According to the World Bank (*World Development Indicators 2002*, table 1.1), in 2000 India ranked 12th among 210 countries and territories in gross national income. In per capita terms, however, in 2000 the country ranked 153rd if incomes are valued using exchange rates based on purchasing power parity, and 159th if incomes are valued using the World Bank's "atlas" method.<sup>3</sup>

India became independent from British colonial rule on August 15, 1947. It is a republic with a parliamentary system of government, an indirectly elected president who serves as the head of state, and the leader of a party or coalition of parties that commands a majority in the lower house of Parliament who serves as the prime minister and head of the government. It consists of 28 states and 7 union (federal) territories, including the national capital region of Delhi. Its administrative and political system evolved mostly during British rule of roughly a century and a half, beginning in the late eighteenth century when the East India Company gained control over coastal areas and ending with direct rule by the British Crown during the period 1828–1947.

India adopted a republican constitution in 1950, with a Westminster form of parliamentary government based on universal adult suffrage. The Constitution is federal but has strong unitary features, such as provisions allowing the central government to invoke emergency powers and dismiss duly elected state governments. It also contains certain unique features, such as a list of Fundamental Rights of the People and a set of (non-justiciable) Directive Principles for state policy.<sup>4</sup>

The relationship between state and central governments has undergone substantial changes since Independence. Before the death of the first prime minister, Jawaharlal Nehru, in 1964, most of the state and the central governments were under the control of the Congress Party, and conflicts between the center and states were resolved within the Congress

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3. The "atlas" method converts national currency units to dollars at prevailing exchange rates, adjusted for inflation and averaged over three years. A dollar at purchasing power parity (i.e., an international dollar) buys the same amount of goods and services in a country's domestic market as a (domestic) dollar would buy in the United States.

4. These, inter alia, enjoined the state to secure a social order in which social, economic, and political justice informed all institutions of national life, to minimize social and economic inequalities among individuals and groups, and to ensure that the operation of the economic system did not lead to the concentration of wealth and that all citizens were entitled to work, education, and public assistance while sick or unemployed.

Party, in which some state leaders were influential. Indira Gandhi, during her long tenure as prime minister, systematically eliminated challenges to her leadership from any independent-minded state leader of her own party.

With the disintegration of the Congress Party and the emergence of regional parties, however, the possibility of a single party ruling at the center, let alone at the center and in most states, is becoming less and less likely. The economic power of the central government has also eroded with the dismantling of central government's control of the economy since the reforms. India's 28 states, some of which have populations exceeding those of most countries, have come into their own in the post-1991 reform era. We discuss the policy challenges associated with this political decentralization in the final chapter of the book.

## **Economic Development Strategy and Performance: An Overview**

That India was desperately poor, and that rapid economic development was essential for alleviating poverty, were realities evident to the leaders of the country's struggle for independence. The traumatic partition of colonial India at Independence along religious lines delayed efforts to address this situation, but the nation embarked on development planning once the immediate tasks of resettling refugees,<sup>5</sup> integrating hundreds of erstwhile princely states into the Indian Union, and rehabilitating the economic infrastructure that had become rundown during World War II had been accomplished.

Nationalists have often argued that British imperialism destroyed the economy and prevented industrialization and rapid development. Others, however, have claimed that without British rule there would not have been a nation-state and a subcontinental common market called India or Pakistan. Clearly, the legacy from British rule of legal, administrative, and political institutions (albeit limited in their decision-making power and in their representativeness) was very important for post-Independence India. However, the integrity, efficiency, and equity of these institutions regrettably have deteriorated since Independence.

The economic achievements of the British era were decidedly mixed. The population of the Indian subcontinent was estimated by the demographer Kingsley Davis to have been 125 million in 1750. It doubled to 255 million in 1871, the year of the first population census, and to 389 million

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5. Almost the entire community of Hindus and Sikhs from Western Pakistan and a large part from Eastern Pakistan (now Bangladesh) came to India as refugees. Although there was a substantial emigration of Muslims to Pakistan, particularly from Eastern Punjab, an overwhelming majority chose to stay in India.

in 1941, the year of the last census under the British (Visaria and Visaria 1983). Real per capita income (index: 1920 = 100) rose from 73 in 1868–69 to 104 in 1930 and fell to 101 by 1945 (Heston 1983). Maddison (2002) estimates that in terms of 1990 international dollars India's per capita income was higher than that of the United States in 1600, but it fell to 42 percent of that of the United States in 1820. The ratio of per capita Indian income to that of the United States fell steadily thereafter, reaching 6 percent in 1950 and a low of 5 percent in 1973, and then recovering to 6 percent in 1998 (Maddison 2002, table C).

India's early industrial growth followed a similar pattern. Morris points out that "between the 1850s, when the first major industries started, and 1914, India had created the world's largest jute manufacturing industry, the fourth- or fifth-largest cotton textile industry . . . and the third-largest railway network" (1983, 553). Even after 1914, Indian industrial growth was rapid—the index of India's manufacturing production, with 1913 as the base, was 239.7 in 1938. Only Japan's production index at 552.0 exceeded that of India—others, including Canada, Chile, Italy, Germany, the United States, and the world as a whole, had a lower index of production (Lal 1988, table 8.5B). Yet at the time of Independence, India was still largely nonindustrialized and one of the world's poorest areas (Morris 1983, 553).

The reasons for this early growth and later stagnation are not entirely clear. Lal (1988, 218), for example, argues that neither free trade nor *laissez-faire* held back Indian industrialization, but the inadequate provision of social overhead capital did. Indigenous entrepreneurs were, after all, able to mobilize capital and establish a modern textile industry under the colonial policy regime. Nevertheless, nationalist leaders, intellectuals, and businessmen agreed "that *laissez-faire* was the root of all evil and central planning the new panacea" (Lal 1988, 229). We turn next to this consensus and the roots of the post-Independence development strategy.

The foundations of India's first development strategy were laid in the pre-Independence era, when several individuals and groups published their plans presenting their vision of India's future development.<sup>6</sup> The engineer and statesman Sir Mokshagundam Visvesvaraya's plan, published in 1934, was one of the earliest. The Indian National Congress's National Planning Committee was next. The committee, under the chairmanship of future Prime Minister Nehru, completed its work in 1938, when most of its members were put in prison by the colonial authorities. As World War II was coming to a close, a group of businessmen from Bombay published their plan, which came to be called the Bombay Plan (Thakurdas et al. 1944). The Indian Federation of Labor, representing the organized labor unions, published its own plan, called The People's Plan (Banerjee,

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6. Even the colonial government had prepared economic plans to be implemented once World War II had ended.

Parikh, and Tarkunde 1944). And the followers of Mahatma Gandhi, who was the champion of handicrafts and village industries, also put out their plan (Agarwal 1960).

All the plans except that of the Gandhians advocated industrialization and import substitution, with the state taking a dominant role in the economy. The planners—impressed by what they perceived as the success of the Soviet Union in transforming a backward agricultural economy into an industrial one in a single generation and also by the economic rejuvenation of Nazi Germany under state direction—all accepted centralized planning as the framework for economic management.<sup>7</sup> The world economy during the interwar period was marked by high tariff barriers, competitive devaluations, and a global depression that resulted in a collapse of world trade and private capital flows. This disastrous experience naturally led to the belief that foreign trade and capital could no longer be engines of growth. Free markets and free trade were also perceived as economic arrangements imposed on India by its colonial masters for their own benefit.

Achieving self-reliance, particularly in manufactured goods, and restricting foreign trade to the bare minimum became dominant objectives. Although India was predominantly an agricultural economy and an overwhelming majority of India's population was poor and rural, the consensus (again with the notable exception of the Gandhians) was that industrialization with an emphasis on large-scale plants and the production of capital goods and intermediates was the only appropriate development strategy for India.

Visvesvaraya asserted that "India cannot prosper except through industrialization [which] has to be organized, planned and worked for . . . India may be an industrially developed country or it may be a market for manufactured goods from outside and not both" (1934, 351–53). Nehru's National Planning Committee concluded that "the problems of poverty and unemployment, of national defense and of economic regeneration in general cannot be solved without industrialization" (Nehru 1946, 401). It further explained:

The three fundamental requirements of India, if she is to develop industrially and otherwise, are a heavy engineering and machine-making industry, scientific research institutes and electric power. (Nehru 1946, 416)

The objective for the country as a whole was the attainment, as far as possible, of national self-sufficiency. International trade was certainly not excluded, but we were anxious to avoid being drawn into the whirlpool of economic imperialism. The first charge on the country's produce should be to meet the domestic

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7. Although the enormous human cost of Soviet industrialization under Joseph Stalin was not then known, it is interesting that the businessmen's plan did hint at the possibility that the human cost was high.

needs. . . . Surplus production would not be dumped abroad but be used for exchange of commodities as we might require. To base our national economy on export markets might lead to conflicts with other nations and to sudden upsets when those markets were closed to us. (Nehru 1946, 403)

The businessmen's and the labor unions' plans also endorsed the emphasis on industrialization and self-sufficiency. With the establishment of the Planning Commission in March 1950, India turned to planning to translate the goals of social and economic policy prescribed in the Directive Principles of the Constitution into a national program based upon an assessment of needs and resources.

During World War II, the colonial government had established an elaborate administrative machinery to allocate scarce commodities and foreign exchange. A system of rationing in urban areas of cloth, food grains, sugar, kerosene, and other essential commodities had been set up as well. India accumulated claims denominated in UK pounds sterling during this period, because imports were severely restricted and there were large exports in support of the United Kingdom's war effort. The accumulated current account surpluses, known as sterling balances, were sizable at the end of the war. Although the United Kingdom's agreement was needed to draw on them (at that time sterling was not convertible), the availability of these balances as part of foreign exchange reserves provided a sizable cushion for an expansionary policy.

At the dawn of planning for development, the government thus had in place a system of administrative controls on the economy to use if it chose. Not only did it choose to use, expand, and tighten these controls over the years, it justified the policy as essential for promoting rapid economic development.<sup>8</sup>

The First Five-Year Plan (1951–56) was more of a compendium of investment projects that had been initiated earlier than a fully articulated and forward-looking development strategy. The analytical underpinning of the first plan was a simple one-sector Harrod-Domar model for consistently projecting growth, savings, and investment rates. It turned out—with the dominant agricultural sector performing well because of good weather, with the growth targets being modest, and with a comfortable

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8. In its very first 5-year plan, the Planning Commission claimed: "Control and regulation of exports and imports, and in the case of certain commodities state trading, are necessary not only from the point of view of utilizing to the best advantage the limited foreign exchange resources available but also for securing an allocation of productive resources of the country in line with targets defined in the Plan. . . . Viewed in the proper perspective, controls are but another aspect of the problem of incentives, for to the extent that controls limit the freedom of action on the part of certain classes, they provide correspondingly an incentive to certain others and the practical problem is to balance the loss of satisfaction in one case against the gain in the other. *For one to ask for fuller employment and more rapid development and at the same time to object to controls is obviously to support two contradictory objectives*" (GOI-PC 1951, 42–43; emphasis added).

balance of payments situation arising from the boom in exports due to the Korean War—that the first plan was successful in achieving its targets without creating any significant fiscal or balance of payments problem.

The successful completion of the modest first plan was followed by a very ambitious Second Five-Year Plan. The plan's author, P.C. Mahalanobis, provided an analytical foundation for it with a closed-economy growth model with two sectors, one of which produced consumer goods and the other investment goods, with sector-specific capital as the only factor of production<sup>9</sup> (Mahalanobis 1955).

The fundamental insight of this model was that the greater the proportion of investment devoted to increasing the capacity of the investment-goods sector, the faster the long-run growth in consumption and investment. In the strategy based on this model, rapid long-run growth was to be achieved without much sacrifice of short-run consumption by concentrating scarce investment in expanding capital-goods-producing (and intermediate-goods-producing) heavy industry. Current consumption demand was to be met by employing abundant labor resources to manufacture consumer goods using labor-intensive methods that required little capital.

The massive step-up in investment envisaged in the second plan resulted in a severe balance of payments crunch in 1957 that led to the institution of a regime of import controls. However, much of the investment in heavy industries took place in the 1960s and 1970s, and subsequent plans did not emphasize these industries as much and somewhat deviated from the Mahalanobis strategy. These deviations were more in the nature of ad hoc responses to emerging circumstances than the consequences of a deliberate reconsideration of the strategy.

Briefly stated (for a more detailed discussion, see chapter 2), Indian economic performance under this development strategy was poor. For three decades until 1980–81 the average annual rate of growth of real GDP was 3.75 percent. With the population growing at nearly 2.25 percent a year, income per head grew at about 1.50 percent. With such a low rate of growth, it is no surprise there was little reduction in poverty—the proportion of the population with consumption below a very modest poverty line fluctuated around an average of more than 50 percent. The economy was insulated from world markets—India's share of world merchandise exports declined from about 2.2 percent in 1948 to 0.5 percent in the early 1980s. The 1979 share of foreign trade (exports and imports) in GDP, 16 percent, was probably no higher than it had been in the early 1950s, having declined in between to 10 percent.

The fiscal expansionism of the 1980s, accompanied by some liberalization of controls on economic activity, generated real GDP growth of more

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9. Although the model had been articulated in 1928 by Fel'dman (1928) for the Soviet Union, Mahalanobis arrived at it independently (see Mahalanobis 1955).



than 5.8 percent a year, and the country's proportion of poor people declined significantly. Macroeconomic policies were conservative up to the 1980s. In the early 1980s, conservatism gave way to an expansionist fiscal policy, which resulted in rising fiscal deficits that were financed by borrowing at home and abroad at commercial rates, as we discuss in later chapters. This expansionism, however, was not sustainable and led to the macroeconomic crisis of 1991.<sup>10</sup>

India's post-1991 era of reforms stands in sharp contrast to the earlier period of its postcolonial economic history. The 1950s' legacy of public-sector-dominated, centrally planned, autarkic industrialization has given way to promarket, prointernational trade policies designed to promote the cross-border flow of goods, services, and factors of production. We firmly believe that the continuation of India's reformist agenda of liberalizing domestic markets and opening up its economy will not only help India but also benefit the world economy by enlarging mutually beneficial and gainful avenues of exchange. The expected benefits for both India and the world will be even greater if India's unilateral efforts are matched by further liberalization of the international economic environment. We explore these important issues in the subsequent chapters of the book.

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10. Although the overall fiscal deficit as a proportion of GDP climbed back to its 1991–92 crisis level by 2001–02, there was no increase in the current account deficit and no sense of a macroeconomic crisis. The main reason for this is the poor domestic investment climate since 1996–97.