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Report

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The Untold Story of India's Economy

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As India looks towards further liberalisation, it must first prepare its economic institutions by re-orienting them from managing the economy to regulating the economy. Without an enhancement of regulatory capacity, increased liberalisation will simply perpetuate corruption and further inequality. By improving regulatory capacity, the state can better focus on the socio-economic aspects of governance that will be so important for India's future. In order to better direct and manage institutional change in India, we must first look to history to understand how India's economic infrastructure was built.

Rather than focusing solely on GDP projections, inflation figures, and unemployment rates, this article discusses a more subtle but much more influential aspect of India's economy. Assessing India's economic trajectory by connecting the modern economy to history and politics highlights the historical driving forces that structured India's market, and anticipates the changes those structures may undergo in the future. The continued development of India is contingent on having the institutional capacity to support growth.

Table 1: India Economic Forecast

%	2012	2013	2014	2015	2016
GDP Growth	7.8%	8.3%	8.4%	8.5%	8.6%
Industrial Production Growth	6.0%	7.5%	7.9%	7.9%	7.9%
Unemployment Rate	9.8%	9.6%	9.3%	8.9%	9.9%
Consumer Price Inflation	8.5%	8.4%	7.9%	7.5%	6.7%
Short-term Interbank Rate	9.9%	9.3%	12.0%	11.8%	11.8%
Government Balance (% of GDP)	-5.2%	-4.7%	-5.0%	-4.3%	-3.9%

Source: Economist Intelligence Unit as of Dec 1st 2011

POLITICS OF DEVELOPMENT

Markets are rarely left to their own devices because they operate within a political economic framework where the distribution of wealth is inherently political. The structural foundations of a country are determined by how that distribution of wealth and political interference shapes the domestic market. In India, the most obvious example of market intervention is its closed capital account.

The fact that capital controls exist is a serious consideration in understanding the Indian economy. Most economists deride India's capital controls and proclaim that India should immediately move to an open capital account and further liberalise its markets. So why doesn't Manhoman Singh, the fearless liberaliser of the 1990s who, as finance minister, navigated India through a deep financial crisis and spurred economic growth via partial liberalisation, further open the economy? What would be the consequences of freer capital flows? Is government intervention not inhibiting economic growth?

Indian technocrats and politicians are being neither obstinate nor politically motivated when they decide to restrict capital flows and monitor the movement of the Rupee in international markets. Certainly politics plays a role. Millions of India's poor tend to protest against liberalisation, as demonstrated by the recent proposal to liberalise India's retail sector to permit greater foreign participation. But the politics behind India's capital controls are not tied to party politics. When the right-leaning opposition, BJP, was in power, Prime Minister Vajpayee was also unable or unwilling to enact broad liberalisation measures. India has liberalised very slowly because of the microeconomic realities faced by the poorest Indian citizens.

Elections are won or lost, and livelihoods made or broken, because of domestic food prices. The Green Revolution in India that began in the 1960s helped prevent famine but not hunger, especially during severe droughts in the mid 1960s, early 1970s, and late 1980s. One of the great marvels of modern technology has indeed been India's ability to feed itself, but with severe overpopulation and underdeveloped infrastructure, the balance between supply and demand remains precarious.

The impact of food price volatility is therefore keenly felt in India. Empirically, the power of food prices is most vividly demonstrated by the Indian Consumer Price Index (CPI). Table 2 compares India's CPI to a developed country's CPI. Food and core staples comprise practically the entirety of the index in India because of the extreme poverty that many face in the country. A slight movement in food prices can have a disastrous effect on India's poor, who are ill prepared to cope with volatility. Food prices and domestic inflation are key incentives to keep the capital account closed, an important consideration that is frequently overlooked.

THE SOURCES OF INDIA'S ECONOMIC STRUCTURES

When the British left India, many wondered whether the Indian subcontinent would remain as one country or divide into dozens of more-or-less sovereign states. India is a nation of nations. Historically, each region had developed under its own political system, being united only because of foreign imperialists. The British managed India through a system of patronage that preserved a certain amount of independence regionally. British interests in India were principally economic, so they left the politics to the locals – as best they could. As a result, when India began to contemplate independence, it was far from certain that it would be a single country.

Table 2: Consumer Price Index

%	India	UK
Food	47.13%	16.00%
Housing	16.41%	12.90%
Clothing	7.00%	6.20%
Fuel	5.48%	N/A
Recreation	N/A	14.70%
Other	23.95%	50.20%

Source: Government of India Ministry of Statistics; UK Office for National Statistics

Despite the legacy of fragmentation, Gandhi, Nehru, and many of India's leaders envisioned a united India surviving the British. The economic ideology of India's forefathers focused on *Swadeshi*, or self-sufficiency. *Swadeshi* was used not only as a political strategy to undermine British economic interests before independence but also as the basis for structuring India's economic foundations after independence. Gandhi envisioned an independent India that was self-sufficient and largely agrarian. Nehru was a bit more grounded in economic reality and strove for industrialisation, but in a manner that was reliant on domestic industry. At the core of both Gandhi and Nehru's vision was a powerful federal government at the centre that could promote national unity and facilitate progressive social change.

As India sought to organise its economy, it looked abroad for successful models that would enable it to industrialise rapidly. The centralised systems of the USSR and China were appealing to India because of the social equality that their systems strove for. Japan was appealing because of its cooperative, self-reliant economic model that helped it develop rapidly. India was by no means communist, but the country had a severe problem of poverty and underdevelopment. The cooperative, equality-driven systems of India's neighbours were therefore more attractive than the uncertainty of Western Capitalism, and the lesson Indian policymakers drew was that countries that industrialised late required state intervention to succeed. The centralised institutions of British India were easily adapted to the centrally planned model that succeeded it in independent India. Today, the remnants of the state-centred bureaucracy continue to influence economic governance.

PHASES OF INDIAN ECONOMIC HISTORY

India's economic history is commonly divided into four periods: roughly independence to 1965, 1966 to 1980, 1981 to 1991, and post 1991. The periods are defined as such because they mark clear breaks in economic policies in India and can be identified with shifts in economic growth rates (see table 3).

The first period is tied to Nehru's reign as president. Under Nehru's leadership, state-centred economic planning reigned. Planners sought to combat economic stagnation and extreme poverty through state driven policies. The top-down economic model helped sustain relatively stable economic growth for two reasons. First, India was undergoing a phase of rapid industrialisation and recovering from years of economic suppression under the British. Second, and more importantly, Nehru was largely able to implement his economic programmes because the powerful Indian Congress Party dominated the country politically and held sufficient power to ensure that the plans reached the microeconomy.

Table 3: Indian Economic Performance

	Phase 1 1951-1965	Phase II 1965-1981	Phase III 1981-1991	Phase IV post 1991*
Key Prime Ministers	Nehru	Shastri I. Gandhi Desai	I. Gandhi R. Gandhi	Rao Vajpayee Singh
Compound Annual Growth Rate**	4.0%	3.5%	5.0%	6.3%
Growth Rate Standard Deviation	2.4%	3.7%	2.1%	2.3%
Years of sub 0% Growth	1	2	0	0

*data included to 2009

**GDP data is based on prices since 1951 and base year of 1999-00

Sources: Reserve Bank of India Statistical Database, Sibal - *Trajectories of Indian Capitalism* (2011)

Nehru's charisma helped build consensus around his vision of India, which translated into political economic coherence. An activist developmental state was more successful in the first phase of India's economic path because of the broad based consensus that existed politically.

When Nehru passed away, the underlying political consensus that held the Congress Party together began to fall away and natural cleavages in Indian politics – representing the diversity of social classes, ethnicities, and nations – began to influence the political order. The Congress Party was still able to win majorities but in order to lead successive Prime Ministers Shastri and Indira Gandhi had to bargain. In this second phase, interests had to be reconciled and that was often accomplished through financial means. Members of the Congress Party needed each other to stay in power and control the national purse but Members of Parliament had vested interests that were largely incoherent at a group level. The net effect of the underlying cleavages meant that the post-Nehru period was marked by a period of incoherence between the macroeconomy and microeconomy.

While the federal government continued to implement centrally driven economic policies in line with state-defined developmental needs, many technocrats disagreed with the policies, sometimes for economic reasons and sometimes for political reasons. Moreover, policymakers, on occasion, simply took advantage of the institutional weaknesses inherent in a country as complicated as India to steal from the system. Without proper execution of policy in the microeconomy, economic planning is futile. Nevertheless, the dream of Swadeshi persisted. The state was viewed as a conduit through which a post-modern Indian state could be facilitated. Public sector corporations could enable cooperation between and amongst different ethnic groups and castes, much better than could the private sector.

Focusing on national unity, at the expense of economic development, cost India dearly. India's economy had anaemic growth and extreme volatility between 1965 and 1981. The standard deviation of India's economic growth rates was greater than the compound annual growth rate over the period. The inability for the federal government to build consensus in this second phase of India's economic history is best represented by Indira Gandhi.

During her first period as Prime Minister, Indira Gandhi worked hard to expand the powers of the state by controlling ever greater portions of the national economy. She constrained domestic businesses with the Monopolies and Restrictive Trade Practices Act of 1969, nationalised banking with the Banking Companies Act of 1969, controlled productivity through the Industrial Licensing Acts of 1970 and 1973, and kept out foreign investment with the Foreign Exchange Regulation Act of 1973. The symbolic culmination of this increase in state power in Indian politics was the Prime Minister's two years of emergency rule beginning in 1975.

The top-down model of state-led economic development was unsustainable without political consensus and the participation of microeconomic actors. The diversity of India was proving too much to handle for state planners. When Indira Gandhi returned to power in the early 1980s (because competing political parties were unable to build a majority consensus in Parliament), she knew that an alternative economic paradigm was needed. Business interests began to be permitted a more active voice in economic planning in India, especially after Indira Gandhi's assassination and the rise of Rajiv Gandhi. The state continued to be at the centre of the system, but businesses were given freedom to operate without as much state interference. In this third phase in the 1980s, with businesses better able to drive efficiency and react to supply and demand incentives, the economy took off. The state, however, continued to manage capital flows and business in certain sectors. The costs of state intervention proved to be insurmountable in the early 1990s and India, like many of its developing country peers, succumbed to a fiscally induced debt crisis. India had to turn to the International Monetary Fund for financing, and the crisis helped usher in change that seemed impossible merely one or two years earlier.

The reforms of Manmohan Singh loosened the clamps on the economy and allowed economic stakeholders to organise themselves to drive greater economic efficiency. Almost immediately the

macroeconomy responded, achieving consistently strong economic growth. Millions have been lifted out of poverty and a new, burgeoning middle class has established itself in India. That India achieved such growth with relatively limited liberalisation, however, is surprising. While this fourth period is marked by greater separation between the government and the economy, the state continues to run a number of enterprises, maintain control over foreign exchange, manage productivity in certain sectors, and protect labour through rigid laws. India took major strides in permitting enterprises to react to market signals but maintained control over India's exposure to the global economy by retaining a tightly controlled capital account.

The phases of Indian Capitalism are outlined to demonstrate the role that the state has played in economic performance. Developmental states are only successful when economic stakeholders are fighting for the same goals. Interests must be protected and integrated into the model of development. The challenge in India is that the heterogeneity of interests proved difficult to align. After independence, under Nehru, the political cohesiveness and dominance of the Congress Party permitted a form of state-based capitalism to be relatively successful. Once the post-independence euphoria had worn off, however, the cooperation necessary to operate a developmental state no longer existed. During phase two the developmental state gradually morphed into an autocratic state, but India's democratic roots proved durable and elections were quickly restored. In phase three, businesses were given greater freedoms to manage production, and the fourth phase made permanent the removal of the state from certain aspects of the economy.

The failure of the developmental state has proven that the state, in India, should not be playing an active role in managing productivity in the economy and that economic stakeholders can efficiently organise themselves. The economy has performed best when economic stakeholders are allowed to react to supply and demand incentives in the marketplace and organise amongst themselves with minimal interference. The challenge, however, is aligning the economic performance with India's political demand for broader distribution of economic wealth. While certain segments of the Indian population have benefitted from liberalisation, many have not. The state has tried to protect those left behind through policies that attempt to shield India's poor from the volatility of globalisation.

LOOKING FORWARD

The Indian economy operates on a delicate balance of state intervention and free market principles. In the past two decades, layers of the state have been gradually worn away after having been built up over centuries of centrally organised economic coordination. Indian companies have thrived with liberalisation, revealing the entrepreneurial spirit of the Indian people. How the state governs the market remains one of the biggest potential barriers to future success. Economic institutions are slowly moving away from managing output towards being regulators, and they should continue in that direction.

The fact that the state continues to have a heavy hand in the market should be no surprise given the history of India's economic governance. The pace of change in governing institutions usually lags that of the marketplace. In developing countries, where liberalisation often results from new policies after state-backed regimes essentially go bankrupt, political institutions are ill-equipped to handle the dynamism of a liberal marketplace. The fact that India has liberalised slowly can actually be considered somewhat beneficial for the political aspects of institutional change.

Looking ahead, the form and function of state institutions, and how they manage and/or regulate the market, represents a bottleneck for further economic expansion. India is ranked 132nd in the World Bank/IFC Doing Business Index, one spot behind the West Bank and Gaza. In the categories where India's ranking is the poorest, dealing with construction permits and enforcing contracts, India has a rank of 181 and 182, respectively, out of 183 countries ranked. As long as the state maintains a focus on managing the economy, inefficient allocation of resources will continue. India's Institutions are built on legacies of

colonialism and state dominated capitalism. Indian institutions, instead, need to become more transparent and focus on regulating the economy.

India's ability to liberalise its capital account is entirely dependent on state institutions being able to adequately regulate the marketplace and manage the systemic risk that results from increased capital flows. If left to their own devices, those institutions will continue to languish. The impetus for change will have to come from microeconomic actors whose growth prospects are being constrained. Even something as simple as the Hazare anti-corruption movement in 2011 has instigated a push for change in India's economic infrastructure. A cleaner, more transparent marketplace, with a more friendly business environment, will eventually allow the state to remove itself from the sectors of the economy where it continues to manage productivity. The state can then better focus on social programmes, such as education and healthcare, that provide a minimum standard for all of India's citizens.

The future for India is bright. As economists call for liberalisation, they should also be cognisant of context. Without institutional change and an enhancement of India's regulatory capacity, increased liberalisation will simply perpetuate corruption and further inequality. Only through a re-orientation of the economic infrastructure will India be able to synthesise the fruits of liberalisation – greater foreign direct investment, deeper domestic market liquidity, and a floating exchange rate – into tangible economic growth, while containing the ills of liberalisation – increased food price volatility and flighty capital.

As for India's place in the global economy, given the vast developmental challenges that remain domestically, it would be difficult to imagine India asserting its economic dominance in international markets any time soon. Processes of institutional change tend to take decades rather than years, and, as a result, the rise of India as an economic superpower will only occur over a long period of time. ■