Prospects of Further Reforms in India

1. Introduction[1]

This note discusses the following question:

- Are economic reforms in India likely to continue or run out of steam?

Ever since India achieved independence in 1947, Nehru-Gandhian socialist philosophy had kept India's economy closed with significant barriers to trade and investment. Government regulation of domestic and foreign trade has been widespread, and controls on the private sector have been tight. Economic inefficiencies at every step kept the annual rate of real GDP growth in India at about four percent from 1955 to 1990. This relatively slow growth, and the policies supporting self-reliance through import-substitution, led to an increasing gap between Indian savings and the country's investment needs.

By the 1980s, policymakers realized that India needed foreign investment to make up the shortfall in domestic saving. In the 1980s, India also set out to attract investment by non-resident Indians (NRIs). Since India's international diaspora is largely made up of professionals, India mostly attracted short-term portfolio investment rather than more stable foreign direct investment FDI.

India, however, did not use new investment to shift the economy to export orientation. State-owned enterprises (SOEs) and India's huge bureaucracy were eating up a substantial share of tax revenues. The fiscal deficit climbed to 8.3% of India's GDP in 1990. As India was unable to reduce its external debt service payments as a proportion of exports, India's credit rating went down. Consequently, in 1991, the international Indian diaspora began withdrawing its portfolio holdings in India. The resulting balance of payments crisis of 1991 forced India to seek help from the World Bank and the International Monetary Fund (IMF).

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