

Book Reviews

Shankar Acharya and Rakesh Mohan (eds.) *India's Economy—Performance and Challenges: Essays in Honour of Montek Singh Ahluwalia*. New Delhi: Oxford University Press, 2010. xv+465 pages.

This volume comprises a compilation of essays written by distinguished Indian economists, and international economists and observers on India, in honour of Montek Singh Ahluwalia, an eminent economist and currently Deputy Chairman, Planning Commission, widely recognised as one of the main architects and drivers of the economic reform process.

In a very well-written Introduction to this festschrift, capturing the essence of the contributions to the volume and weaving them into an excellent overview, Shankar Acharya and Rakesh Mohan state, “Indeed the story of India’s economic policies over the past three decades could easily be woven around Montek’s career as the pre-eminent government economist through most of this time”. This role is earlier acknowledged in the foreword to the volume by the current Indian Prime Minister, Manmohan Singh, the initiator of the overall reform process as Finance Minister from 1991-96, when Montek (as he is popularly known) worked under him in important positions. This recognition also finds strong support amongst the authors, who were close associates of Montek in policy-making, as they recount the role he played in both shaping and driving the economic policy reform agenda. How a small but well-knit team of economists, most of whom had earlier worked in the World Bank or the IMF, could actually achieve this in a country as large and complex as India would baffle any observer. While the book provides no explicit answer, the reform process appears to have initially found favour in response to the economic crisis in 1991. The process then gained momentum as the reforms showed measurable success, and this helped win over the trust and confidence of the political ruling élite.

If there is one clear message from this book, it is that macroeconomic and financial stability which India was able to achieve provided a firm foundation and played a pivotal role in propelling the Indian economy from its earlier anaemic performance (or “hindu growth rate” of 3 percent, as popularly dubbed) to one which was able to generate very high levels of economic growth with low inflation. A major part of this volume (and one from which economists can learn the most) is how the reform process was put in place to bring about this economic and financial stability in a challenging and changing domestic and global economic environment.

To quote Acharya and Mohan from their Introduction, “The Indian economy is now very different from what it was at the turn of the 1990s, as are its banks, financial markets, and the capital market. The economy as a whole is much more integrated with

the rest of the world: the current account is fully open while the capital account is substantially so. The tax regime has undergone substantial reform: direct taxes now form the bulk of tax receipts, customs duties are approaching [the] ASEAN level, and domestic indirect taxes have been substantially reformed towards a value-added regime. Interest rates have been deregulated to a large extent towards market determination, and the banking system now exhibits a much greater degree of competition after the introduction of new private sector banks and the listing of all public sector banks”.

The essays in this volume are divided into four parts. The first addresses broad issues related to overall growth, inequality and reform; the next focuses on the evolution of macroeconomic and financial policies; the third discusses sectoral issues; and the fourth examines issues relating to India’s place in the world.

In Part I Surjit Bhalla (described in the introductory overview as “a provocative analyst of development policy”, a description to which, having known Surjit, this reviewer fully subscribes), provides a detailed critique of the monetary policy stance taken by the Reserve Bank of India (RBI), which in his view was primarily responsible for the break in the economic growth momentum generated in the late 1990s and post-2008. While later authors contest somewhat convincingly this view, there is no denying Bhalla’s central point—that exchange rate and interest rate are key determinants in driving India’s economic growth (as indeed that of most developing countries including Pakistan). Bhalla argues that the RBI, with its emphasis on monetary aggregates, unnecessarily slowed down the economy when they resorted to monetary tightening as money supply grew faster than what they considered prudent. Much in line with the current debate in Pakistan over the influence of interest rates in controlling inflation, Bhalla argues that money supply has little bearing on inflation, which in India is primarily determined by international developments.

The second essay in Part I, by Suresh Tendulkar, analyses the distinction between inequity and inequality in the context of the larger debate in the development literature on this issue. This essay is more academic in nature as compared to the rest in this volume, but the author’s in-depth analysis of key issues in this debate shows his grasp over this contentious issue. It is by now well-established that periods of high economic growth have historically been associated with an increase in inequality. Tendulkar makes the important point that the perception that this is also inequitable, and in this sense undesirable for it generates social tensions, depends very much on what happens to the incomes and standards of living of the lower income groups and the economic and upward mobility opportunities this growth provides for them. Since the rest of the volume is somewhat silent on the issues of poverty and inequality during the period of high growth, can one infer that this viewpoint is the one to which the authors associated with the reform process sympathise?

At the core of this volume are the essays in Part II, by Shankar Acharya and Rakesh Mohan—to which also should be added the essay by C. Rangarajan in Part I—which analyse in careful detail how India went about achieving sustainable macroeconomic stability through far-reaching economic reforms after the financial crisis in 1991 (which included the heart-wrenching sight for most Indians of seeing their gold reserves taken by creditors as collateral in chartered flights bound for Zurich and London to avoid complete financial collapse).

The high period of success of the economic reform undertaken was between 2003-08, which, as Acharya documents, saw the Indian economy achieve on average a remarkable economic growth of 8.8 percent, with low inflation (4.5 percent), relatively low fiscal deficit (6.6 percent), a comfortable current account trade deficit (0.4 percent), and high levels of foreign exchange reserves. This growth was driven by an almost fifty percent increase in gross domestic investment, which rose to 37.5 percent in 2007-08 from 25.2 percent in 2002-03, financed by a domestic savings rate that soared to 34.8 percent in 2006-07 from 23.6 percent in 2000-02. This meant that growth was financed through domestic resources with little recourse to foreign savings, i.e., foreign borrowings. This was indeed a “golden age”, and India’s best economic performance since Independence over fifty-five years ago.

What were the principal causes behind this remarkable turn-around?

Perhaps the most important in terms of ensuring macroeconomic stability was fiscal consolidation. As Acharya points out: “Large fiscal deficits tend to pre-empt loanable funds, foster high real interest rates and crowd out productive investment. In 2001-02 the combined fiscal deficit of Central and State governments had attained a record level of 9.9 percent. “Fortunately”, as Acharya explains, “both central and state governments grasped the gravity of the fiscal imbalance and began to take decisive action”. Indeed it was a combined effort. The major rise in central government revenues came from increases in direct taxes, notably corporate and income taxes, with which they bolstered state revenues by giving them an increasing share of the central pool as recommended by the Twelfth Finance Commission. The state governments also achieved the impossible feat of reaching an agreement on a uniform value-added tax and shifted from the earlier system of divergent rates of sales taxes. The result was that the combined fiscal deficit of the central and state governments fell to much more manageable levels than in the earlier years.

Clearly, fiscal consolidation and reduction in the fiscal deficit, and the resulting easing of monetary pressures as government borrowings declined, played an important part in paving the way for the economy to move to a higher growth plane. There were, however, two other factors which played an important role in achieving this turn-around which the authors identify but do not give sufficient credit to (perhaps because they were driven more by external forces on which their influence was accordingly limited).

The first was the large increases in export earnings, mainly driven by a gigantic leap in software exports, from \$5.7 billion in 2000-01 to \$ 37 billion in 2007-08. This was indeed a “manna from heaven” in that it resulted from technological advancements in ICT outside India. It was India’s good fortune that it had the trained human resources to take advantage of this opening through their earlier large investments in setting up state-of-the-art institutes of technology, which now paid rich dividends.

The second was the large increase in foreign capital inflows, which rose from \$10 billion in 2002-03 to \$106 billion a year in 2007-08. Foreign reserves, therefore, correspondingly increased from \$76 billion in March 2003 to \$310 billion in March 2008. These were driven in part by foreign investors’ confidence in the Indian economy and the relatively higher returns (including interest rates) as compared to the developed economies. Yet, they were in part a mixed blessing as they exerted pressure on the exchange rate to appreciate and to erode export competitiveness. But what should not be

denied is that these very large foreign exchange reserves provided a comfort zone to the policy-makers in pursuing the reforms they had initiated.

It may be important to point out here that the set of economic reforms undertaken by the Indian policy-makers in themselves were not ingenious; they are fairly standard recommendations of the IFIs (International Financial Institutions, mainly the IMF and the World Bank). These basically aim for key economic variables to be determined by market realities, rather than suppressing these forces through government interventions, which not only distort the incentive structure but also leave policies open to government whims, vested interests, and the resulting corrupt practices.

In this context, what really strikes one as one follows the reform process is the skills (and confidence?) of the Indian policy-makers in taking pragmatic decisions and not be tied down by the prevailing orthodoxy (“Washington Consensus”) which gave them the room to manoeuvre to adapt and gear the reforms to the needs of the economy. There is much here that policy-makers in the developing countries could learn from (including those in Pakistan—and one may add, those who work for the IMF and the World Bank.)

A very good example of this is not fully opening-up of the capital account or making the Indian currency fully convertible, as was being recommended at the time by the IFIs, and forcefully so by the Indian large business interests. Here the measured approach adopted by Indian policy-makers stands in sharp contrast to that adopted by Pakistan’s policy-makers, who opened up to a much larger extent the capital account and, for all practical purposes, made the Pak rupee convertible at the very start of the reform process in the early 1990s. A result of this was that the foreign exchange accounts of overseas Pakistanis and other among Pakistan’s nationals had to be frozen to prevent their large-scale exodus after the nuclear bomb blast in 1998, with considerable loss of business confidence. This measure is also partly responsible for Pakistan’s roller-coaster ride in maintaining adequate foreign exchange reserves, and its frequent recourse to the IMF to bail it out, with resulting stabilisation and periods of low economic growth.

The same pragmatism could be seen in the Indian policy-makers’ approach in not allowing the exchange rate to appreciate as their foreign exchange reserves increased manifold due to foreign inflows. By intervening in the foreign exchange markets, the RBI deliberately ensured that the exchange rate remained in a band which did not erode India’s export competitiveness, instead of its being driven by purely market forces.

Shankar’s overview and analysis of macroeconomic developments in the Indian economy is built upon further by an equally absorbing analysis by Rakesh Mohan on the monetary policy pursued and the financial reforms undertaken during this period. Rakesh demonstrates how these resulted in following a monetary policy, especially in the determination of interest rates by market forces and limits over government borrowing from the RBI and commercial banks, that contributed in a major way to ensuring macro stability and low rates of inflation. The considerable improvements in the performance of the Indian banking sector in this period is attributed to both the induction of new private sector banks and disinvesting public sector banks—and to listing them and “gradually introducing international best practices, the phased tightening of prudential norms, enhanced supervision and the like.”

The other essays in this volume cover sectoral perspectives (agriculture, infrastructure, social sectors, and services sector), as well as a global perspective by eminent international economists and prominent commentators on the Indian as well as global economy. There is also a chapter by Nicolas Stern, *et al.*, on the role India could play in achieving a global deal on climate change.

It is not possible to cover all the essays in this rich volume in this review and do justice to them. For those wanting excellent summaries of all the contributions included in this volume there is no better place to find them than in the succinct and very readable introduction by Acharya and Mohan.

But perhaps a few remarks on some of the contributions may be in order. Isher Ahluwalia's review of social sector development, though based on the Indian Punjab but applicable to much of India (and indeed Pakistan), is a solemn reminder that despite impressive growth, India has still a long way to go in the delivery of good quality social services, especially in education and health. Isher presents a number of indicators to show the dismal performance of the government in service delivery. The expanding role of the private sector in service delivery may improve results in terms of the numbers covered, but it is at a cost in excluding those who cannot afford them, and also the quality delivered in most cases is still very poor despite the higher prices charged. Without real improvements in the HRD indicators, both qualitative and in coverage, India's future growth prospects remain seriously threatened.

The well-known international trade economist and former Chief Economist at the World Bank, Anne Krueger, makes the important observation that despite impressive growth in exports, the trade reforms undertaken have not led to the growth of labour-intensive exports, which are vitally needed to absorb the large surplus labour in India's agriculture sector and low-productivity informal economy in the urban areas. Krueger argues that the growth of software exports does not directly create jobs for the unskilled or even semi-skilled labour, and though it does generate jobs in supporting industries, the numbers are still small in the context of the Indian economy. Krueger makes a strong case for encouraging the growth of labour-intensive manufacturing which she argues is essential to create productive and remunerative jobs in sufficient numbers and thus reduce poverty.

Ashok Gulati, in his essay on accelerating agricultural growth ("moving from farming to value-chains"), deals with the sector on which India's future prospects and reducing poverty so critically hinge, with more than half of the workforce (52 percent) still employed there even though its share in GDP has been reduced over time to only 18.5 percent in 2007-08. While subject to wide fluctuations, the trend growth rate of India's agriculture was 3 percent between 1985-86 and 2008-09, which is respectable though below the set target (4 percent). Gulati examines the future sources of growth in agriculture and how India needs to maintain a reasonable degree of food security. The most important part of his essay is on the needed reforms in the agriculture sector, which he rightly headlines "Reforming the Three 'I's: Investments, Incentives and Institutions". There is much to learn from his insightful analysis of needed reforms, which may be implemented if India (and indeed most developing countries) are to galvanise this critical sector to higher value-added production and sustainable higher agricultural growth.

Gajendra Haldeas in his essay presents an overview of key infrastructure sectors, the role played by the public sector, and India's experience with developing the public-private partnership in building the badly needed infrastructure to sustain high economic growth. Haldeas makes the important point that with deregulation and privatisation in sectors like industry, the infrastructure sector is now prey to more corruption in the award of contracts. Turning to the failures of regulation, Haldeas states: "The regulators in India have been created by statutes, and are supposedly independent of government control. However, the near-complete absence of accountability, compounded by the lack of any overarching philosophy of regulation, does not bode well for the orderly growth of infrastructure in India". Further, the well-known and widely read journalist Martin Wolf, in reviewing what he sees as India's role in the world, states that, first and foremost, it must raise the standards of living of its still widespread poor population.

However, one major drawback is that the volume is silent on the issue of poverty and the standard of living of most Indians and one is left guessing as to how much of the gains of economic growth have indeed been passed on to the ordinary Indian people. Also, the volume only cursorily touches upon how policy-makers dealt with the financial crisis, but this may well be because the essays were written as the crisis was still unfolding.

But for now his friends and acquaintances have honoured Montek Singh Ahluwalia's with a volume that certainly comes up to the stature and expectations of the economist they honour.

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