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Opportunities in India

Consequences of Liberalization and Globalization

Tapen Sinha and Dipendra Sinha

Introduction

In mid-1991, India was at the crossroads. Its foreign exchange reserves were down to almost zero. The newly elected Congress Party was able to form a government only with the help of left-wing smaller regional parties. Inflation was running into double figures. The Indian Government sought an *emergency* loan from the International Monetary Fund (IMF) for the first time in July 1991.

The most pressing problem was the balance of payment crisis. The crisis had two (unanticipated) causes:

(1) The Gulf War, which led to a large exodus of Indian workers from the Middle East back to India, depriving her of substantial invisible exports. It imported additional price rises in the form of higher oil prices.

(2) The collapse of India's main trading partner: the Soviet Union.

With substantial encouragement (and arm-twisting) from the World Bank and the IMF, the Indian Government decided to embark on a (risky) path of economic reform. The reform process has opened India up for foreign investment and the huge market of goods and services.

There are three main directions of reform:

(1) deregulation within the economy to reduce business regulations;

(2) reduction of business taxes;

(3) increased external trade and investment by exchange rate reforms and dismantling of tariffs and quotas.

We shall evaluate all three directions.

Economic Backdrop

To understand the economic changes, it is necessary to look at the current economic conditions under which the changes are taking place. First, consider the gross domestic product (GDP). As a crude measure of the wellbeing of an economy, GDP gives us a broad picture. However, the usual reported figure is fundamentally flawed. A more appropriate measure is the purchasing power parity (PPP) adjusted GDP. The PPP adjusted GDP puts India as the sixth largest economy in the world.

A broad economic picture of India is contained in Table I. A substantial proportion of the population is still very poor. Approximately 300 million people still live below the poverty line. However, the sheer size of the economy makes the total number of people with substantial purchasing power still very large.

Recent Economic Report Card

There are a number of dimensions from which we measure the economic progress of a country:

- *Real GDP growth:* This is routinely used as a prime indicator of wellbeing, but it is unreliable. The Indian population is growing at the rate of 2 percent. Therefore,

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Gross domestic product (GDP)	US$1,062 billion (PPP adjusted)
GDP growth rate 1994: 6.0 percent	1993: 5.5 percent
Foreign debt (Dec. 1993)	US$73.5 billion
Short-term interest rate	18 percent
Market capitalization	US$130 billion
Listed companies	Over 7,000
Population	902 million
Middle-class population	150-200 million
English-speaking	50 million
Investors	25-30 million
Life expectancy (at birth)	61 years
Literacy rate	53 percent
Sources:[1,2]	

Table I.
Economic Indicators of India

just to keep the same per capita real GDP, the Indian economy needs to grow by at least 2 percent. Real GDP growth rate *minus* the population growth rate would be a better indicator.

- *Agricultural production:* This had been one of the main indicators for agrarian economies. However, in recent times, the share of agriculture of GDP has been falling. Therefore a less than spectacular rise in agricultural production would be less significant. Variability of monsoon from year to year makes agriculture an inherently risky business. Hence projection of agricultural output into the future is fraught with difficulties.
- *Savings rate:* To propel a country into a high-growth path, a prerequisite is a high rate of savings. Savings lead to capital formation, which, in turn, spurs future growth. On both counts, India exhibits good promise. However, saving does not magically convert itself into productive investment. India has had a high rate of savings over the past two decades, but most of the money has been locked away in unproductive areas such as speculative housing investments in some key areas of the country.
- *Government budget deficits:* Fiscal deficits are of obvious importance to a country. It gives a measure of how well the Government is performing. Similarly, the consumer price index is a measure of the responsibility of the central bank.
  For a country such as India, which had decades of inward-looking policies, the growth rate of exports is of significance.
- *Other measures:* As parts of financial activity, growth in the stock market, earnings per share and price earnings ratio are all indicators of economic activities in the country. The projections show that all the indications are positive (see Table II).

Indian economic policy since independence in 1947 has been characterized by regulation. It has a large public sector and also has protected sectors. The first serious reversal of that policy was adopted in the first budget of the minority party-supported Congress Government led by Prime Minister Narasimha Rao and his Finance Minister Dr Manmohan Singh in 1991.

For the most part, the results are healthy. However, the reduction in budget deficit was not. In the next section, we look at why this was the case.

An Anatomy of the Government Sector

Traditionally, central Government has played a very big role in Indian economic affairs. State and local governments do not have much political or economic power. The central party in power manipulates regional governments extensively.

The central Government faced constant budget deficit. Part of the deficit was monetized leading to double-figure inflation in the fiscal years 1990-91 (13.6 percent) and 1991-92 (13.5 percent). Part of it was paid for by selling Government bonds. This process raised the interest repayment component of the Government's budget. It also crowded out private investment and raised the domestic interest rate.

	Percentage change			
	1991-92	1992-93	1993-94 (est.)	1994-95 (est.)
Real GDP	1.2	5	6	6.2
Agricultural production	–2.5	4.8	3.1	4.5
Industrial production	–0.1	1.3	4.5	6.5
Savings rate	24.3	23.9	24.1	25.6
Capital formation	25.5	25	25.4	26.5
Fiscal deficit	6	6.1	6.4	5
Current account balance	–1	–2.1	–1.1	–0.2
Exports	–0.8	2.2	17	20
Imports	–18.8	11.1	8	12
Consumer price index	13.5	9.6	8.5	6
Bombay Stock Exchange Index	1,879	2,800	3,500	5,000
Earnings per share	4	–10	29.5	35
Price earnings ratio	26	29	22	16

Source: Center for Monitoring the Indian Economy quoted in [3]

Table II.
Changes in Indian Economy – Now and Future

Tax mixes as a revenue-raising process needed a change. Customs duty, as a part of tax revenue, is becoming increasingly important, whereas revenue generated from income tax has been falling (see Table III). Customs as a measure of revenue generation has two important negative effects:

(1) it breeds corruption and consequent loss in revenue; and

(2) it leads to smuggling, which in turn leads to a loss in potential revenue.

India's income tax base has eroded tremendously. At present, only 7 million people are paying direct income tax. For a country with a middle class of at least 200 million, this is a problem for the Government.

The Government is trying to amend the situation by:

- offering an amnesty to past non-payers;
- reducing the tax rates to reduce non-compliance of future taxpayers.

The current pool of non-payers is huge. The part of the economy unaccounted for owing to non-reporting is estimated to be 25-50 percent of the overall economy[5]. Therefore giving a blanket amnesty has generated political tension between the Government and the leftist parties. Reduction of tax rates is also controversial. The Government believes that the current rates are too high; a reduction in rates will actually bring in more revenue (the so-called "Laffer Effect"). However, this is a risky path because the size of such an effect is uncertain.

Fiscal year	Income tax	Customs	Excise duty	Sales tax	Other
1980	14.2	17.2	32.8	20.2	15.6
1985	12.4	22.0	29.9	20.2	15.4
1991	12.7	25.2	26.1	20.5	15.5

Source: Calculated from [4]

Table III.
Revenue Sources for Indian Government (in Percentages)

Financial Implications

When we look at the domestic stock market, one striking feature stands out: the number of individuals who directly own company shares. At least 20 million Indians directly own shares in different companies. This is larger than the population of Australia and Malaysia. Most of the shares are owned by small investors. Large companies routinely hold their shareholders' meeting in football stadiums filled to capacity.

The size of the stock market is also quite substantial. India has 24 stock exchanges (22 currently operating). However, Bombay is the largest with 70-80 percent of the total market value. Capitalization in the Bombay stock exchange was about US$100 billion (on December 31 1993). The Asian stock markets larger than Bombay are Tokyo ($3,100bn); Hong Kong ($370bn); Kuala Lumpur ($227bn); Taipei ($190bn); Seoul ($142bn); Singapore ($134bn); and Bangkok ($122bn)[6].

Capitalization of the stock market is about to rise significantly for the following reasons. In more traditional stock markets the largest listed companies tend to be banks and insurance companies. The Indian Government nationalized most large banks in 1969 and insurance companies even earlier. Therefore large-scale capital is still to hit the market. By some estimates, the value of the stock market in India will treble once banks and insurance companies become listed[7]. The Reserve Bank of India (RBI) has taken the first steps to privatize the banking sector. The first private bank in 25 years, the UTI Bank Limited (backed by the largest mutual fund in India, United Trust of India), has just opened its doors. There are at least a dozen potential banks waiting for clearance from the RBI. At present, public sector banks hold about 87 percent of all bank deposits[8]. Mining, railways, airlines, utilities are yet to be privatized. Therefore the growth potential is very large for the stock market.

Integrating India to the Global Economy

Indian policy makers believe that any deregulation *within* the economy must go hand in hand with integration with the world economy. This was not the model followed by most of the other Asian countries in the past such as Korea or even Japan.

A prerequisite for integration with the rest of the world was taken to be integration of the Indian rupee in the world currency market. The Indian rupee, like many other currencies of developing countries, was overvalued. As a consequence, an elaborate *havala* (Hindi word meaning unofficial or parallel) market developed. Before moves to convertibility, *havala* rates remained at 20-25 percent above the official rate[9]. It was thought by the RBI that sudden, full convertibility would bring chaos to the currency market. Therefore, the RBI decided to make the Indian rupee convertible in several steps. The first step was to make any transaction convertible with a 60-40 split: 60 percent of the money would be convertible at the "market" rate and the rest, 40 percent, at the official rate. The second step would be "full" convertibility in trade accounts. However, this is not to be confused with unrestricted purchasing rights of Indians in markets abroad or unrestricted purchase by foreigners in Indian markets. There are still *quantity* restrictions. However, *all* permitted goods will be allowed to be converted at the market rate. The third step will be full convertibility in the sense used by OECD countries.

The first step was implemented in July 1991 with a 20 percent devaluation of the rupee. The value of the rupee in the official market fell and got closer to the *havala* rate. The premium for the *havala* rate declined to about 17 percent.

An important second step was taken on March 2 1993. Partial convertibility of rupees was changed to full convertibility in trade accounts. That is, the market was allowed to

determine one single rate and *all* transactions took place at that rate.This move was unanticipated by the exporters and other traders who use rupees for foreign currency.

Many expected the rupee to fall substantially below 31 rupees per US$ (the exchange rate at the time). However, this did not happen. At first, the value of the rupee fluctuated wildly but then, within a month, it started to trade in a narrow band. The premium in the *havala* market almost evaporated. Today, the premium is no more than 2-3 percent above the market rate.

In late 1993 and early 1994, Indian businesses started to borrow in the Eurobond market to raise capital, thus raising the demand for the Indian rupee. The rupee started appreciating against major foreign currencies. Under pressure from exporters, the RBI intervened in the currency market to keep the rupee *down* for the first time in its history.

With the rise of foreign exchange reserves, there is intense speculation about convertibility of the rupee in capital accounts. Some commentators believe it will happen before the 1995 Union Budget[9].

Foreign Investments

Since the 1950s, India has pursued an isolationist policy of "self-sufficiency". One corollary was an active discouragement of foreign investment in India. In the name of "national interest", many industries were nationalized (e.g. banking, coal, steel). It sat well with India's foreign policy of maintaining a "special relation" with the Soviet Union, which itself had followed similar policies (although for different reasons). It was highly popular within the country. The culmination of the pursuit of an isolationist policy in India came to a climax in 1977 when Coca-Cola and IBM were forced out of the country. In the 1980s India made several overtures to improve trade links with the USA and its allies, but were snubbed because India was seen to be too close to the Soviet Union. Thus India's main trading partner remained the Soviet Union and its allies.

Break-up of the Soviet Union brought large-scale changes in export and import out of necessity for India. With changes in the tax regime, a lowering of barriers to foreign ownership of businesses in India and the allowance of repatriation of profits, the Indian Government has opened up India to foreign investors such as never before. This had a tremendous impact on the growth of foreign investment in India. In 1990-91, foreign investment amounted to US$165 *million*. In 1993-94, that figure stands at US$3.0 billion (half of which came from American companies). This is a substantial change. If we compare it with China, however, this figure looks small. Therefore India still can attract much more foreign capital than it already has.

There are several dimensions to attracting foreign investment:

(1) access to the domestic market;

(2) export of profits;

(3) favorable tax rates;

(4) political stability.

Compared with China, India has a more stable political environment. It has a better developed legal system. A substantial number of people can communicate in English, the *lingua franca* of the business world. Foreign businesses are attracted to the institutional depth which India has, but which China has not.

The stability of India is reflected in the resilience of the stock markets in India to "big" political events such as the demolition of a Mosque in Ayodhya and the ensuing riots around India, or the bombing of the stock exchange building in Bombay. The biggest drop in the stock market came in April 1992 with the stock market scandal that has rocked the existing system of transactions to the core.

When the initial bouts of deregulation were implemented in 1991, the ruling Congress

Government was in power with the support of a number of minority parties in the Parliament. In the next two-and-a-half years, it has consolidated that power by winning a number of by-elections and some regional and state governments. Thus the stability of the changes has strengthened and the process appears to be irreversible. The stock market has also taken the indicators of stability on board. Immediately after the crucial state elections in November 1993, the stock market climbed significantly.

Marketing Implications

There are 30 million television sets in India. In many urban areas of India, local cable operators have sprung up, providing cable access to 22 percent of all television owners[8]. Cable television provides its own Hindi language programs along with Cable News Network (CNN), Music Television (MTV) and a whole range of programs originating in the USA. The most popular channel has been the ZeeTV operated by Rupert Murdoch's Star Television out of Hong Kong. As a result, India's burgeoning middle class has become aware of many Western brand names. Clearly this provides an avenue to set up and market fast food, breakfast cereals, etc., for the multinational food giants. Companies such as PepsiCo (which wholly owns Kentucky Fried Chicken and Pizza Hut), General Foods, and Kellogg's and MacDonald's are already setting up operations in India.

For marketers, challenges lie ahead. First, Indian taste-buds are not like those of Westerners. Most Western foods are considered bland by Indians. Therefore fast food must be modified to suit Indian taste. Second, food habits and tastes across India also vary widely. Third, there are religious restrictions on food. For example, 85 percent of Indians are Hindus. Most Hindus abhor eating beef. Thus the staple hamburgers from MacDonald's will not exactly be a bestseller. If MacDonald's tries to sell beef products in India, most Hindus will not buy *anything* there. MacDonald's is developing a new line of "lambburgers" and "vegeburgers" to be marketed exclusively in India.

Some food items have succeeded in penetrating the pan-Indian market, even though they were not a part of the Indian staple diet before. For example, noodles have become a regular feature for the middle class in India today, although just 20 years ago it was considered exotic by most Indians.

Obviously, beaming commercials to 902 million people does not do a company any good unless people have purchasing power. It is estimated that the Indian middle class now includes some 250 million people – the population of the USA. Visa Credit Card Company recently estimated that at least 40 million Indians have an annual income of US$30,000[10]. There are at least 10,000 millionaires in US terms. Therefore, even though 40 million people represent less than 5 percent of the population in India, it is very large in absolute numbers (twice the size of Malaysia).

The Future

Reforms in India have not embraced all parts of the economy equally. Some commentators have argued that only the "easy" parts of the problems have been addressed so far[11]. One major player in the economy is the (centralized) bureaucratic system. Relatively speaking, it takes up a substantial part of the economy. However, anecdotal evidence suggests that Government-run organizations are extremely inefficient. There are some test cases which point to major inefficiencies in Government operations. For example, local transport in large cities is partly run by Government and partly by private operators. In *every* case, Government-run buses lose money, whereas private operations are highly profitable.

Thus a bureaucratically-run Government with its existing structures is not going to produce efficient outcomes. A drastic plan

might have tried to overhaul the bureaucracy. However, the Government seems to have taken a more gradual approach to reform there. For example, in many Government-run agencies (which are known to have inefficiencies), jobs lost through natural wastage (through death, retirement and resignations) are simply not being filled.

Policy makers hope that, over time, Government influence on the economy will decline with the growth in the rest of the economy.

In some sectors of the economy (especially in traditional manufacturing and processing), labor unions are very powerful. However, the political power of labor unions (through the left-wing political parties) seems to be waning. In the state elections in 1992 and again in 1993, many of these leftist parties (and also right-wing parties) lost power in the legislative assemblies.

There is some concern about Indian military expansion. India has fought three wars with neighboring Pakistan and another with the other Asian giant, China. With the help of the Soviet Union, India developed medium-range missile technology. It has also made significant advances in nuclear capabilities. Some countries, including Australia, see India as an emerging threat to peace in the South East Asian region.

If we examine the evidence in Table IV, we find India's expenditure on defence is small relative to that of China in absolute value. As a percentage of GDP, it is smaller than China's and much smaller than Pakistan's expenditure. More significantly, this proportion is falling (Table V).

India has established a fairly long tradition of democratically elected governments and very little political power to the military. The same cannot be said about either China or Pakistan. Therefore it is unlikely that India will flex its military might in the region. However, in India, politicians feel that they do not get the same respect from Western countries as China does. For evidence, they point to the permanent membership of China in the Security Council of the United Nations. There are political gains to be made domestically by making the Indian military stronger. Moreover, an external threat from Pakistan and China cannot be completely discounted. Therefore it is unlikely that India will *substantially* reduce military expenditure.

Regional tensions and religious riots have become an integral part of India's political scene. British India was split into two, roughly along religious lines. However, India ended up with more Muslims in the country than neighboring Pakistan or Bangladesh. Two Indian prime ministers have died at the hands of political assassins; there have been periodic religious riots, and there has been violence in parts of the country where ethnic or religious minorities wanted either to secede or gain more autonomy. In the past decade, there were three such regional problems in Punjab, Kashmir and Assam. Much of it can be attributed to perceived economic deprivation.

This kind of violence for similar reasons has also been observed in other parts of the world. Consider the example of Lebanon. In the early

	US$ billion					
	1979	1981	1983	1985	1987	1989
China	26.950	23.640	23.220	22.600	22.030	22.330
India	5.131	5.795	6.911	7.584	8.900	8.174
Pakistan	1.063	1.261	1.768	1.990	2.257	2.488

Source:[12]

Table IV.
Military Expenditure

	Year						
	1986	1987	1988	1989	1990	1991	1992
China	10.7	9.1	7.9	6.0	4.8	3.9	4.9
Pakistan	7.57	7.61	8.56	7.62	7.16	6.93	7.14
India	4.04	4.06	3.79	3.61	3.33	3.06	2.75

Source:[13]

Table V.
Defence Expenditures (as Percentage of GNP)

1970s, Lebanon was developing quickly, but most of its Muslim population was not sharing the wealth. However, they obtained arms and finance from some Arab countries. This resulted in a civil war which lasted 20 years. Similar events took place in Kashmir. The impoverished Muslim population aided by Pakistan revolted against rule by India. What happened in Punjab was similar to the events of Northern Ireland. Here the support for the terrorists came from rich Irish expatriates now living in the USA. For Punjab, it came from Sikh expatriates from all over the world.

These uprisings have one common element: relative poverty. If India does succeed in an economically sustained boom, such squabbles will dissipate rapidly. Take the case of Singapore. Even in 1964, Singapore was definitely a part of the Third World. It was considered a liability to the Malayasian Federation. So Malaysia decided to drop Singapore from the federation. Ethnic and religious tension, following a series of riots, was high. The spectacular economic successes in one generation of Singaporeans have eased the religious and ethnic tensions between the Chinese Buddhists and Christians, Malay Muslims and Indian Hindus. Therefore with economic growth political problems are likely to ease.

□

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