Asian Studies Center

Backgrounder

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RESPONDING TO INDIA'S WELCOME ECONOMIC REFORMS

INTRODUCTION

Socialism, it is now universally recognized, is thoroughly discredited as an economic model across Eastern Europe and the Soviet Union. There it did enormous economic damage. Yet nowhere has the combination of socialist economic and anti-trade policies proved more of a failure to more people than in India. There the victims of economic failure are counted in the hundreds of millions.

While Asia's economic powerhouses like Hong Kong, Japan, the Republic of China (ROC) on Taiwan, the Republic of Korea, and Singapore were using exports as an engine for growth, India remained hostile toward trade. And while Southeast Asia's newer generation of economic miracles like Indonesia, Malaysia, and Thailand were deregulating their economies to encourage foreign private investment, India's cumbersome bureaucracy swelled.

Few Western companies have had the patience to endure New Delhi's complex licensing regulations or to pay India's high import duties. Those who did were limited to only 40 percent ownership of assets in India; even then, most of their products had to be exported, leaving India's population of 850 million mainly domestic products of inferior quality and inflated price.

Stagnant Economy. With few trade and foreign investment links to the West, India's economy predictably stagnated. The average annual increase in industrial output between 1960 and 1988 was only 5.5 percent, less than nearly every other Asian nation.[1] Annual growth in industrial output in South Korea and the ROC during this

1 Bangladesh, Sri Lanka, and Myanmar (Burma) recorded slightly lower average increases in industrial output.

period, by comparison, was 16.5 and 13.2 percent, respectively. India's agricultural output suffered too, averaging an annual increase since 1970 of only 2.1 percent, less than half that of Malaysia and Thailand.

Half a Nation in Poverty. Meanwhile, Indians living in poverty, according to the World Bank, climbed to 55 percent of the population between 1973 and 1983, worse even than the average for sub-Sahara Africa during the same years.[2] This year, in the United Nations ranking of 160 nations according to life expectancy, adult literacy, education, and per capita income, India places 37 from the bottom; in Asia, only Bhutan, Cambodia, Laos, and Nepal rank lower.

This spring, India's economic future looked bleaker than at any time since India's independence in 1947. In February, the International Monetary Fund cut off loans to New Delhi when the weak coalition government of Prime Minister Chandra Shekhar collapsed, leaving India with nearly $75 billion in foreign debt, and less than $1 billion in foreign exchange reserves, enough to cover only two weeks of imports. Worse, there was the possibility that, for the first time, India would miss payment of its international loans.

Then in May, former Prime Minister Rajiv Gandhi, the front runner in the national elections for a new prime minister and widely touted as the only man capable of turning around the economy, was assassinated. When Narasimha Rao, a seventy-year old politician known for his weak leadership, was announced as the compromise choice for prime minister in June, many predicted that India's economic situation would grow even darker.

Fledgling Economic Revolution. The pundits now appear to have guessed wrong. In his first month in power, Prime Minister Rao mounted a frontal attack on India's four-decade experiment with socialism. His new government has slashed bureaucracy, lowered the number of government-controlled industries, and devalued India's currency, the *rupee*, by 18 percent. More important, Rao openly criticized New Delhi's long-standing policy of economic self-reliance, and in doing so took aim at India's traditional bias against trade and foreign investment. So great were these changes that even *The Economist* magazine, long a critic of India's socialist failures, was heaping uncharacteristic praise on New Delhi for its fledgling economic revolution.[3]

Praise too is coming from foreign businesses. With 380 million consumers above the poverty line, over four times larger than the population of any European country, the Indian market is tempting. Both Ford Motor Company and International Business Machines, Inc., received permission from New Delhi's revamped Foreign Investment Approval Board during the last week of September to launch joint ventures in India. Similar approval was given this month to General Motors Corporation and the Kellogg Company. Even The Coca Cola Company, which abandoned India in 1977 after New

2 *The Economist*, May 4, 1991, p. 8.
3 *The Economist*, July 13, 1991, p. 36.

Delhi demanded it reveal its secret formula, is seeking to return with a proposal for a factory outside of New Delhi.[4]

But the Indian economy still faces numerous hurdles. Opening India to trade will expose many of its inefficient domestic industries to stronger foreign competition. This will increase the pressure for costly subsidies which could end the economic reforms. Problematic, too, will be India's 15 percent inflation and its $75 billion in foreign debt. The Rao government, moreover, is the product of a weak political coalition which may have only one year before being challenged in parliament by the opposition. Rao's own Congress Party, in fact, might edge him out if reforms prove too painful in the short term.

Washington Silent. Throughout these recent dramatic reforms, the United States largely has been silent. Indeed, Washington traditionally has paid scant attention to the Indian subcontinent. Despite India's position as the world's largest democracy, only two U.S. Presidents have visited New Delhi since India became independent: Dwight Eisenhower in 1959 and Jimmy Carter in 1978.

Washington's indifference stemmed largely from New Delhi's ostensibly non-aligned—yet often anti-Western—foreign policy. In addition, India's self-imposed economic isolation kept Indo-U.S. trade ties at a minimum. Although the U.S. is India's single largest foreign investor, American investment in

1990 INDIA DATABOX

Official Name: REPUBLIC OF INDIA

Capital: New Dehli

Head of State: President Ramaswamy Venkatraman

Head of Government: Prime Minister Narasimha Rao (1991)

Area: 1.27 million square miles, about one-third the size of the U.S.

Population: 849.7 million

Gross Domestic Product: $276.[illegible] billion

Per Capita Income: $325

Economic Growth Rate: 4.5%

Inflation: 15.0% (1991)

External Debt: $75 billion (1991)

U.S. Investment: $639 million

Total Exports: $18.2 billion -- engineering goods, textiles, clothing, tea.
Exports to U.S.: $3.2 billion

Total Imports: $26.0 billion -- machinery, transportation equipment, petroleum.
Imports from U.S.: $2.5 billion

Defense Budget: $6.3 billion (1991)

Total Regular Forces: 1.26 million

Source: Kenneth J. Conboy, ed., *U.S. and Asia Statistical Handbook, 1991 Edition*; and from other sources.

Heritage InfoChart

4 *Financial Times*, August 14, 1991, p. 8.

Example: Among India's highly subsidized industries, including most of its heavy industries, wages on average are 70 percent higher than in light industries which are less protected.

Example: To curb unemployment, the Indian government often forbids companies that are losing money from closing down. Nearly 20 percent of loans from India's financial institutions go to prop up 150,000 such failing companies.[5]

THE PROMISE OF RAJIV

By the early 1980s, India was barely keeping its economic head above water. Helping slightly was the *rupee*-ruble arrangement that New Delhi worked out with Moscow. In this socialist economic fantasy, India exported inferior quality products unmarketable in the West, such as soap and garments, to the Soviet Union in return for oil and weapons. Some Indian officials, however, were slowly beginning to realize that the cost of its self-imposed economic isolation was too high.

Ironically, it was Indira Gandhi, elected in 1971 on promises to increase government subsidies, who first attempted to invigorate the Indian economy in the early 1980s by making investment more attractive to foreign private investors. Under her leadership, in 1983 restrictions were eased to permit overseas Indian businessmen to buy and sell shares in Indian firms and to expatriate all profits from India.

INDIA'S PRIME MINISTERS

Jawaharlal Nehru (1889-1964)
1952 ↓ 1964 (Died in Office)

Lal Bahadur Shastri (1904-1966)
1964 ↓ 1966 (Died in Office)

Indira Gandhi (1917-1984)
1966 ↓ 1977 (Lost National Election)

Morarji Desai (1897-present)
1977 ↓ 1979 (Coalition Government Collapsed)

Indira Gandhi (1917-1984)
1980 ↓ 1984 (Assassinated in Office)

Rajiv Gandhi (1944-1991)
1984 ↓ 1989 (Lost National Election)

Vishwanath Pratrap Singh (1931-present)
1989
1990 (Coalition Government Collapsed)

Chandra Shekhar (1927-present)
1990
1991 (Coalition Government Collapsed)

➤ Rajiv Gandhi assassinated while campaigning for Prime Minister: May 21, 1991

Narasimha Rao (1921-present)
1991
Present

Heritage InfoChart

5 *The Economist*, May 4, 1991, p. 6.

Supply-Side Experiment. When Rajiv Gandhi took office in 1984, after his mother, Indira, was assassinated, India got its first taste of supply-side economics. Within a year, the top income tax bracket had been slashed nearly in half from over 97 percent to 50 percent. Corporate taxes were cut from 65 percent to about 50 percent. With lower rates, economic activity increased and tax cheating decreased. The result: government revenues increased 40 percent.

Rajiv Gandhi also trimmed state controls on foreign private investment. He exempted some companies from the time-consuming process of obtaining licenses under the so-called Monopolies and Restrictive Trade Practices Act. He also allowed some companies that had a single license to make more than one product; previously, even slight product variations needed separate production licenses.

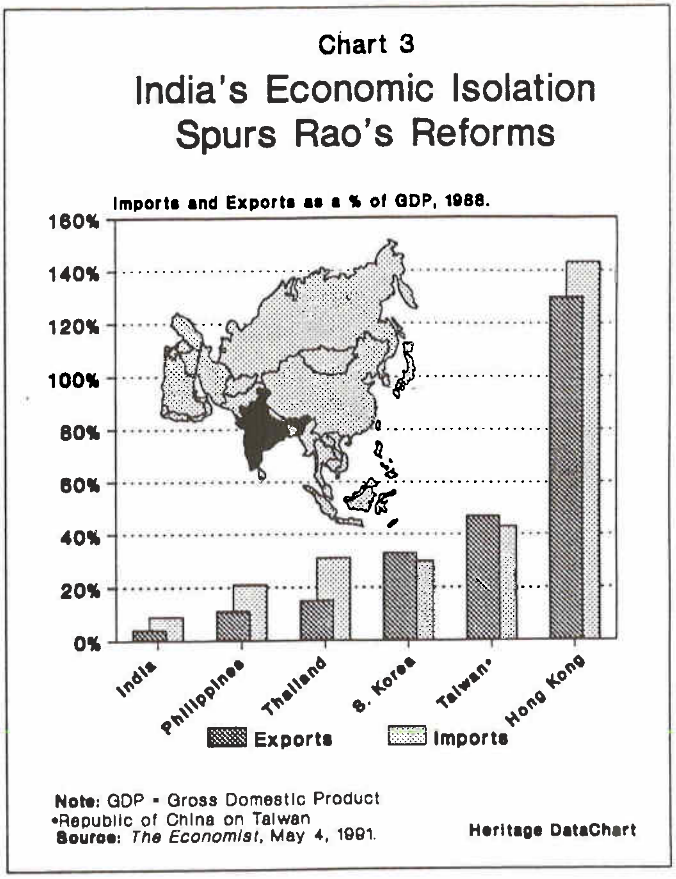
In the end, however, Gandhi's brief burst of liberalization sputtered. A series of corruption scandals in 1987 rocked his administration, and sapped his political power. No longer able to lead, Gandhi could do little as India's infamously lethargic bureaucracy delayed further reforms.

THE RAO REVOLUTION

Gandhi was voted out of office in November 1989 and replaced by a fragile coalition government. His successor as prime minister, V.P. Singh, earlier had been Gandhi's finance minister and was credited with executing Gandhi's initial economic reforms. Before Singh could act, however, rising ethnic violence among Hindus, Muslims, and Sikhs paralyzed his administration. A weak caretaker government under Chandra Shekhar took office in November 1990, but did little as the economy slid further into ruin. By this past spring, India was suffering from:

- **Weak political leadership.** Rajiv Gandhi, the front runner during May national elections and widely touted as the only candidate capable of carrying out successful economic reforms, was assassinated on May 21 by Sri Lankan extremists. As a result, Rajiv's Congress Party, which has dominated Indian politics since independence since 1947, was leaderless.
- **Rising ethnic violence.** Unrest in the states of Assam, Kashmir, and the Punjab undermined the confidence of India's few foreign investors.
- **An economy nearly broke.** Its $75 billion debt makes India the third most indebted country in the world, after Brazil and Mexico. To meet its balance of payments crisis, India this April turned to Japan for $300 million in emergency aid.
- **A drop in exports.** Between April and June this year, India's already small volume of exports fell by 6.6 percent in dollar terms compared with the same period last year.

With the economy near collapse, few gave much hope to Prime Minister P.V. Narasimha Rao when he took office following June national elections. Rao, after all, had no political base of his own, and was merely a weak compromise choice by the Congress Party following Gandhi's assassination. Yet Rao immediately began economic reforms that, by Indian standards, are revolutionary. His program includes three main points:



1) **Raising** the portion of Indian companies that can be owned by foreigners from 40 percent to 51 percent in such industries as chemicals, food processing, hotels, and transportation. While it still is too early to see results, this change is intended to attract more foreign private investment. Rao also has devalued the *rupee* by 18 percent; although Indian exports have dropped 7 percent in dollar terms since devaluation, Indian officials hope the move will make Indian exports like agricultural commodities an-dtextile products more competitive in the world market in the long term.[6]

2) **Streamlining** the government bureaucracy by cutting regulations within the Office of the Chief Controller of Imports and Exports. The Chief Controller began by dropping twenty items, including computer diskettes, from a list of products that previously could be imported only by government-run companies.

3) **Allowing** companies geared toward export to convert 30 percent of export earnings to credits for freely tradeable foreign currencies that can be used to buy imports or sold to other businessmen.[7] This is intended to encourage firms to export more.

If these reforms continue, writes the *Asian Wall Street Journal*, India could increase the foreign investment flowing into the country tenfold over the next five years.[8] Still, Rao has to enact many more reforms if he is to solve New Delhi's major budget and international balance of payments crisis. India still must trim its huge public sector and halt its costly practice of subsidizing failing companies. New Delhi also must secure new loans from the International Monetary Fund by demonstrating political and economic stability if it is not to default on its short-term commercial loans of $4 billion.

6 *The Wall Street Journal*, October 21, 1991, p. 16.
7 *Financial Times*, August 14, 1991, p. 8.
8 *The Asian Wall Street Journal*, August 12, 1991, p. 18.

Intellectual Property Rights. Problems, too, persist with India's widespread violations of international patents, copyrights, and trademarks. American pharmaceutical companies, for example, one of America's most competitive industries, lost an estimated $65 million in Indian sales last year to Indian companies selling pirated copies of American pharmaceuticals. These pirated drugs often are of inferior quality and can hurt the consumer. Intellectual property rights violations, meanwhile, stunt the growth of India's domestic industries because Indian companies will not invest money to develop new products knowing that their patents and copyrights will be stolen by rivals. In addition, without adequate protection of intellectual property rights, India makes itself a target for retaliatory trade restrictions in the U.S., which, in turn, could put strains on other aspects of Indo-U.S. relations.

Further complicating reforms is Rao's own weak political position. He faces opposition not only from rival parties, but from within his own Congress Party. Already he has withstood one confidence vote. More serious challenges may come next year, when financially strapped opposition parties can collect sufficient campaign funds to take on the prime minister.

THE U.S. AND INDIA: DEMOCRACIES AT ODDS

Throughout New Delhi's current economic crisis, Washington's attention understandably has been focused elsewhere, notably on events in the Soviet Union and the Middle East. But scant U.S. interest in the subcontinent is nothing new. Indo-U.S. relations traditionally have come near the bottom of Washington's foreign policy priorities. Only during extreme emergencies did the U.S. take note of events in the subcontinent. In 1962, for example, after India humiliatingly was defeated by the Chinese in their battle over control of India's northeastern border, the Kennedy Administration rushed transport aircraft and military supplies to equip over four new divisions of Indian troops. Then in 1968, Lyndon Johnson used authority granted under Public Law 480 to supply over $2 billion in food aid to New Delhi following two years of drought.

For the most part, however, Indo-U.S. ties have remained minimal. Much of this was due to U.S. displeasure with India's explicitly pro-Soviet brand of "neutrality," which by the 1970s, had become a major irritant in relations between the U.S. and India. No matter what happened in the world, India could be counted on to blame America. India too was a favorite conduit for Moscow-inspired disinformation that, for decades, spread lies about the U.S.

By the early 1980s, however, changes started. In addition to Indira and Rajiv Gandhi's tentative steps toward economic reform, India began openly to express interest in diversifying its arsenal, which largely contained Soviet-designed military equipment. The Reagan Administration signed a Memorandum of Understanding with India in November 1984, paving the way for the U.S. to sell India high technology goods, including some weaponry. As a result, in 1986, Washington allowed the General Electric Company to sell New Delhi its F-404 jet engine, which also powers the U.S. Air Force's F/A-18 *Hornet* fighter plane, for use in India's new Light Combat Aircraft.

Desert Storm Help. Indo-U.S. relations have continued to improve during the Bush Administration. This January, for example, New Delhi allowed U.S. military transport aircraft to refuel in Bombay on their way from the Philippines to the Middle East during Operation Desert Storm. In return, Washington supported a $1 billion loan to India by the International Monetary Fund. The U.S., meanwhile, remains the largest foreign investor in India, although the total investment remains small: U.S. investment in 1990 amounted to $639 million, one-sixth of what American investors poured into tiny Singapore. American investments in India were concentrated in computer software, electronics, telecommunications, and turbines. U.S.-India two-way trade last year was only $5.7 billion, about one-sixth the total of U.S.-South Korean trade and one-seventh that of American trade with the People's Republic of China.

Despite the slight warming in Indo-U.S. relations, bilateral ties remain limited. Members of Congress condemn India for human rights abuses, especially against Kashmiri and Sikh separatist movement extremists. This spring and again this fall, for example, the U.S. Congress strongly criticized Indian military and paramilitary forces for raping and killing Kashmiri civilians. Others in Congress criticize New Delhi for its nuclear weapons program. India first detonated a nuclear bomb in 1974, and since then has been highly secretive about its nuclear weapons research. While it does not admit to a nuclear arsenal, New Delhi will not discount the possibility of producing such weapons in the future to counter perceived nuclear threats from mainland China and Pakistan.

With few ways to pressure India, the U.S. Congress occasionally threatens to cut Washington's meager development assistance program to India, which for fiscal 1992 will total only $22 million. This money is earmarked mainly for child nutrition and agricultural development projects. Washington also has granted $77.6 million in P.L. 480 food aid for fiscal 1992. The Bush Administration opposes the use of these monies for political leverage, noting that threats would only harden India's determination to conduct nuclear research and continue abusive treatment of domestic opposition.

FORGING CLOSER U.S.-INDIAN TRADE TIES

Given the economic potential that could be unleashed by Rao in India, the U.S. should not continue ignoring South Asia. Instead, Washington should try to help New Delhi's economic reforms. In doing so, U.S. companies stand much to gain in the Indian market. American companies, in fact, already have invested more in India than have their Japanese and European competition. By expanding trade and foreign investment links to India, the U.S. may be able to increase its leverage over New Delhi. Increased leverage, in turn, could enable Washington more effectively to pressure New Delhi on issues like nuclear non-proliferation. To give India's economic reforms appropriate encouragement, the Bush Administration should:

- **Arrange for visits to India next year by the Secretaries of State and Commerce.**

Senior Indian officials regularly visit the U.S. Prime Minister Rajiv Gandhi, for example, came to Washington in 1984, 1985, and 1987. Yet senior U.S. officials rarely visit India. The last President to do so was Carter in 1978. Secretary of State James

Baker has never visited India, even though he is the U.S. Chairman of the Joint Indo-U.S. Commission, an official committee charged with increasing bilateral cooperation.

Given the gradual improvements in Indo-U.S. relations since the Reagan Administration, a visit by Secretary Baker early next year would be appropriate. To underscore further U.S. support for Indian economic reforms, Secretary of Commerce Robert Mosbacher should go to India before mid-1992. Both Baker and Mosbacher should urge Rao to continue the reforms, and should emphasize the need for India fully to open other sectors of the economy in which American companies are competitive, like the energy industry, chemicals, and public transportation systems. Baker, moreover, should apply quiet, but strong, pressure on India to support nuclear non-proliferation and halt further ballistic missile development.

♦ **Praise India's economic reforms in speeches by George Bush during his trip next month to Northeast and Southeast Asia.**

Rao's liberalization policies are revolutionary by Indian standards, and likely will face increased domestic opposition as India shifts further toward an open market. Given the Rao government's vulnerability, Bush publicly should offer encouragement for the Indian government's long overdue economic reforms. A good opportunity for such praise would be in speeches made during Bush's trip to Northeast and Southeast Asia this November. Bush specifically should laud New Delhi's more favorable attitude toward trade and urge Rao to continue streamlining the Indian bureaucracy to attract more foreign investment.

♦ **Urge India to adopt effective patent and copyright protection.**

India's protection of intellectual property is among the worst in the world. As a result, foreign companies are leery about entering the Indian market for fear they will lose their investment when their products are copied. For the same reason, Indian businessmen refrain from investing in research and development. To overcome such commercial obstacles, the Bush Administration first should redirect its efforts at the stalled Uruguay Round of the General Agreement on Tariffs and Trade (GATT). Instead of negotiating primarily on the agricultural sector, the U.S. should be working to reach an agreement on intellectual property protection in the GATT that would define intellectual property clearly and would outline international standards for protection of intellectual property.

Next the Bush Administration should make it a priority during high level bilateral meetings to urge the Rao government to include more effective patent and copyright protection as part of its economic reforms. The Administration also should begin negotiating bilateral agreements with New Delhi that would cover intellectual property protection in specific sectors, such as computer software and pharmaceuticals.

♦ **Continue the joint Indo-U.S. military programs like production of the Light Combat Aircraft.**

Limited defense cooperation between the U.S. and India has since the mid-1980s become the main pillar of Indo-U.S. relations. For one thing, Washington gave India $300,000 in fiscal 1991 for training Indian military students in America. For another, U.S. military sales to India have increased since the second Reagan Administration.

American companies such as General Electric provide engines for India's Light Combat Aircraft (LCA) project and gas turbines for India's new frigates. Other U.S. companies like Honeywell Incorporated and the Northrop Corporation are competing to sell avionics for the LCA, rocket radar systems and a Very Low Frequency Communications System for use in submarines.

Washington and New Delhi have since 1989 have been convening annual high level defense seminars hosted by the U.S. National Defense University and India's Institute for Defence Studies and Analysis. For New Delhi, these seminars, which are attended by senior military officers, were the first to be held with a foreign nation despite India's long-standing security relationship with the Soviet Union. In these meetings, Americans and Indians discuss security cooperation and threat perceptions in South Asia.

Although India's defense budget shrank by 9.7 percent in real terms this year because of New Delhi's balance of payments crisis, India still ranks as a regional superpower. New Delhi maintains a 1.3 million-man military, the fifth largest in the world, including 874 combat aircraft and two aircraft carriers. India's relative influence in South Asia, moreover, likely will grow as Washington cuts back on the number of U.S. Navy ships passing through the Indian Ocean.

While economic ties should be at the heart of U.S. policy toward India, Washington should continue to promote defense cooperation with New Delhi. Washington, for example, should urge India to continue developing the LCA, which has been plagued by delays and cost overruns. The LCA is important because it has come to be widely perceived in New Delhi as the litmus test for further large scale joint development ventures between Indian and American defense industries. The U.S., in addition, should hold a third bilateral defense seminar in early 1992 and should urge New Delhi to include more senior active military officers on the Indian panel.

- **Instruct the Department of Commerce to organize delegations of American businessmen to visit India in early 1992.**

During the 1980s, the Department of Commerce organized about one official trade delegation to India each year. Coordinated through the department's Trade Development Office, these delegations were composed of executives from U.S. companies from a specific sector. Though these companies pay their own way, as part of an official delegation they receive better access to Indian government officials than they would have as private visitors. The Department of Commerce led a telecommunications delegation to New Delhi this September. A delegation for food processing companies had been scheduled for early 1992.

Resources within the Commerce Department recently have been shifted toward Latin America. As a result, plans for further U.S. delegations to India have been shelved. High-profile delegations provide an important boost to American companies looking to do business in India. The Department of Commerce should be instructed to schedule its planned visit to India during early 1992 that would focus on such promising sectors as food processing or energy industries.

CONCLUSION

Since 1956, when New Delhi's first formal economic plan took effect, India has been shackled by a statist, centralized economy. New Delhi is finally moving away from this failed socialist model. American companies have much to gain in the immense Indian market. Increased prosperity in India, moreover, could ease the tensions created by India's ancient religious, ethnic, and regional divisions. These threaten India's political and economic stability.

Advancing Democracy and Stability. Reforms to the Indian economy will take time, and could be reversed if the Rao government comes under heavy political pressure from parliamentary opposition. Washington should try to promote the opening of India's economy as the heart of a policy toward India that will advance both democracy and stability in the subcontinent, and put American companies in the forefront to share in the benefits of New Delhi's economic revolution.

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