

VIII ASSESSMENT OF REFORMS

8.1 India's economic reforms were set off by fiscal and external sector compulsions reflected in the crisis of 1991. Though crisis driven, the reforms have been sustained for over a decade. The major thrust driving the reform process was the quest for higher growth and efficiency along with macroeconomic stability. This was sought to be attained through the process of wide consultation to achieve broad social consensus. The approach to reform was therefore gradual but steady. Macroeconomic stabilisation was sought to be achieved by correcting the fiscal, external and monetary imbalances that had become unsustainable by the end of the 1980s. These policy changes were accompanied by structural reforms to impart competitive strength to the real economy. Structural reforms took the form of industrial deregulation, liberalisation of foreign direct investment, trade liberalisation, public enterprise reform and financial sector reform. Structural reforms aimed at reorientation of the economy from a centrally directed command and control economy to a market oriented one to foster greater efficiency and growth. This was done by introducing greater competition in the economy through progressive internal deregulation accompanied by external competition promoted by foreign direct investment and trade liberalisation.

8.2 The reform process has helped accelerate the healthy economic growth of the 1980s in a more sustainable manner, bolstered by greater competitiveness and efficiency gains. Real gross domestic product (GDP) grew at 6.1 per cent during the reform period (1992-93 to 2002-03) higher than that of 5.6 per cent in the pre-reform decade (1981-82 to 1990-91). Per capita income grew at 3.9 per cent in the reform period as against 3.2 per cent in the pre-reform period resulting in a healthy reduction in the poverty ratio. On assessment, India's reform programme has had a definite positive and significant impact on the economy as compared with the past.

8.3 The reform process, however, needs to be strengthened. Convergence calculations suggest that India will take decades to catch up with the middle income emerging market economies that were at the same level of economic development as India was at the time of Independence. To step up growth to 8 per cent and beyond in line with the Tenth Five-Year Plan (2002-07) targets, reforms would have to be further intensified in the agricultural sector, in factor markets to promote flexibility, in bankruptcy and exit procedures, in fiscal consolidation and in physical and social infrastructure sectors to accelerate investment. These are the areas of concern where the pace of reforms needs to be accelerated.

8.4 This Chapter seeks to provide a summary assessment of the reforms undertaken in the respective sectors of the economy. The prospects for future policy reforms at a sectoral level are also identified.

The Real Economy

8.5 The reforms encompassed all the diverse segments of economic activity, though their coverage and depth varied across the different sectors of the economy. The key issue that has arisen in recent years is the deceleration in growth in general, and in industry and agriculture in particular. It is, thus, imperative that the next phase of reforms should lay emphasis on the regeneration of growth in both agriculture and industry. Higher growth in agriculture will come from policy reforms promoting diversification and investment. Industrial deregulation has been substantial but more remains to be done to allow faster restructuring and encourage investment.

There have been some reforms in the services sector also, particularly in infrastructure and the financial sectors. Competition policy and regulation, however, need to be strengthened for these sectors. On balance, more needs to be done in terms of speeding up the reform process and eliminating constraints.

Agriculture

8.6 The development of agriculture is a critical prerequisite for sustaining a high growth process, apart from raising living standards and eradicating poverty of a large proportion of the populace that is directly dependent on agriculture. Reforms in agriculture so far have been largely confined to pricing aspects. Though the terms of trade have moved in favour of agriculture, the existing institutional structure still constrains the growth in this sector.

8.7 Agricultural growth decelerated during the 1990s. Per capita foodgrain availability has remained below the historic peak attained in 1991. Agricultural performance witnessed a dip in the 1990s partly on account of subdued public investment in agriculture and inadequate diversification. The decline in public investment was only partially compensated by the rise in private investment. Real private investment in agriculture did rise significantly, but in the face of declining real public investment in agriculture, overall real capital formation in this sector has been low in recent years. This underscores the need to recognise complementarity between public and private investment.

8.8 Near plateauing of yields in the 1990s indicates that any further improvements in yields are difficult to accrue unless accompanied by new technological breakthroughs and establishment of a proper mechanism for extension. There is a need to promote a more broad-based and participatory system of extension services. The recent scheme of agri-clinics is a welcome step in this direction and will pave the way for greater private sector participation in agricultural extension.

8.9 The issue of mounting agricultural subsidies is a contentious one. It impacts not only the agricultural sector but is also important in the context of fiscal consolidation. Explicit and implicit subsidies for this sector remain large and ill-targeted. The food and fertiliser subsidies are explicit subsidies. In addition, there are three main types of implicit subsidies in the form of subsidies to power, water through public irrigation projects and credit under priority sector lending norms. The excessive and unbalanced use of subsidised inputs can have adverse impact on the performance of agriculture. Appropriate pricing and user charges of such inputs would release resources for improved public investment in new infrastructure projects and for the maintenance of the existing facilities. It is, therefore, important to reduce most of the agricultural subsidies and ensure better targeting of those that are essential for social welfare. However, the subsidy issue is made more complex in the light of falling international agricultural prices. If these prices return to the mid-1990s levels, the need for subsidies will be correspondingly lower.

8.10 A contributing factor to below-potential performance of agriculture is the failure to sufficiently diversify the cropping pattern. The minimum support price (MSP) policy has distorted the relative prices between rice and wheat, on the one hand, and other food and non-food crops, on the other, giving rise to a distorted cropping pattern. It has contributed to a steep rise in the ratio of procurement to production over the years. The higher increase in MSPs of rice and wheat relative to prices of other agricultural commodities has contributed to an incentive structure that favours production of rice and wheat at the cost of other crops. The policy has contributed to a burgeoning stock - far in excess of food security requirements, adding to carrying costs and locked-in bank credit, which could have been otherwise deployed for funding productive activities. In view of the associated costs, there is a need for re-examining the price

support mechanism to eliminate the distortion of agricultural product composition. In line with diversification of the consumption basket of a representative Indian household, there has been some acceleration in the growth of high value-added agricultural products such as milk, fruits and vegetables, poultry, meat and fisheries during the 1990s. It is essential that this trend be reinforced in the coming years from the viewpoint of enhancing producer incomes and nutrition of consumers. Higher agricultural growth will come from crop diversification to non-traditional activities that are in line with the changing agricultural demand pattern.

8.11 Though withdrawal of restrictions on the movement of commodities has been a major component of the reforms in agriculture, some legislative and regulatory constraints have prevented the agricultural sector from exploiting its true potential. Reforms have, however, been substantial in the case of selective credit controls, with only sugar currently being subjected to such controls. Limited de-reservation of items produced in the small-scale sector related to agriculture has been initiated. Some progress has been achieved in setting up of the commodity exchanges for trading in futures and options in agricultural commodities. Further efforts are necessary that would remove distortions (price and non-price interventions) in the output and input markets and facilitate, *inter alia*, price discovery and risk management.

8.12 Several changes have been effected in external trade and exchange rate policies that have significantly improved the incentive structure for the farm sector. Such reforms include progressive liberalisation of quantitative export ceilings and price floors along with decanalisation. As regards imports, policies were directed, *inter alia*, at lowering of tariffs on agricultural inputs and products and broadening of the open general licence (OGL) list. The pace of liberalisation has been relatively faster for dairy products and fruits and vegetables.

8.13 Several measures have been initiated in the 1990s to augment the flow of institutional credit to the rural sector and enhance the efficacy of the credit distribution channel. The growth of direct institutional credit flow towards agriculture and allied activities, however, declined during the 1990s as compared with the 1980s. Coupled with a shift in the composition of credit away from medium/long-term loans, this could have affected capital formation in the private sector. These developments indicate that banks may have targeted relatively risk-free irrigated areas and individuals with high net worth for providing priority sector agricultural loans. In comparison, rain-fed and drought prone areas and relatively poorer households have had greater dependence on informal sources of finance. The deadweight of non-performing assets (NPAs) of agricultural advances has also affected the recycling of credit. The adherence to prudential norms of income recognition, asset classification and provisioning has made banks more conscious of risk. This could have also contributed, at the margin, to deceleration in flow of credit to agriculture.

8.14 There have been two significant innovations in the rural credit delivery mechanism in the 1990s namely, micro finance and the Kisan Credit Cards (KCCs). Micro finance has emerged as an alternative system for rural credit delivery to complement the formal credit institutions. The scheme of micro finance has made significant progress, by linking self-help groups (SHGs) with banks and the number of beneficiaries covered. The loan amount per beneficiary at Rs.1,360 is, however, not adequate to enable the poor to cross the threshold of poverty. Similarly, development of SHGs has been highly uneven across States. There is urgent need to upscale the programme evenly across the States along with an increase in the loan amount per beneficiary.

The outreach of the KCC to cover all eligible farmers under the scheme has been hampered by the lack of updated land records, small landholdings and illiteracy of borrowers. Sensitisation of bank staff to these issues through training would be helpful.

8.15 The performance of Indian agriculture in the 1990s has often been attributed to the lack of reforms in the agricultural sector. Whereas this is not exactly true, more needs to be done for the agriculture sector, both in terms of sequencing and overall priority. For example, futures trading, particularly in foodgrains, should be promoted first so that dependence on MSP mechanism for price stabilisation could be avoided. Similarly, strengthening of public distribution needs to accompany the relaxation of the Essential Commodities Act, 1955 to ensure uninterrupted supplies of foodgrains to the poor at reasonable prices. As most of the vital reform measures in the agricultural sector, *viz.*, removal of inter-State restrictions on movement, storage of and trading in foodgrains, were initiated only recently, their impact is yet to be felt, particularly because of the fact that States have a major role to play in their implementation. The policy of linking allocation of resources from Centre to States with their performance in implementing agricultural reform measures is a step in the right direction.

Industry

8.16 The major objective of reforms in the industrial sector was to attain faster industrial growth aided by improved productivity and efficiency, so as to be competitive, domestically as well as globally. The instruments to achieve these objectives included removal of industrial licensing which abolished restrictions on investment and capacity expansion, de-reservation of industries reserved for the public sector, substantial opening of foreign direct investment and trade liberalisation through elimination of quantitative restrictions and reduction in custom tariffs. These measures resulted in significant removal of entry barriers and provided greater access to foreign technology and capital. Realistic exchange rates and industrial restructuring helped improve the competitiveness of the manufacturing units. The evolving post-reform industrial structure was anticipated to be both more labour and technology-intensive. Enhanced demand for skilled labour was expected to provide positive externalities for the rest of the industry and services sector.

8.17 In retrospect, Indian industry upgraded technology and product quality to a significant degree and met the challenge of openness after being protected for decades. This was reflected in high growth of the industrial sector in the initial phase of reform. This exuberance reflected in high growth in investment and production in industry during 1993-94 to 1996-97, particularly in manufacturing, however, could not be sustained. Although the growth process has been to some extent influenced by global business cycles, the persisting deceleration in Indian industrial growth is, in part, attributed to the slowdown in reform momentum and inadequacy of certain major structural reforms. Today, the industrial sector confronts challenges of a continued slowdown, stagnation in contribution to GDP, and a sluggish employment growth. When benchmarked against other fast growing emerging economies, the performance of the Indian industrial sector appears a bit lacklustre. In an increasingly global environment, the sector continues to face structural constraints, such as inadequate, relatively inefficient and high cost infrastructure, high cost of borrowed funds, inflexibilities in labour markets and other institutional rigidities that inhibit the pace of industrial restructuring. Ultimately these factors impinge adversely on the cost structure of industry, thereby hampering its competitiveness.

8.18 The prolonged lull in the equity market resulted in financing of corporates through high cost leveraged funds. This has led to a debt overhang for the corporate sector. In addition, the decline in international prices of manufactured goods in recent years has had adverse implications on the corporate balance sheet, in terms of squeezed profit margins. The proportion of interest to total costs for Indian corporates is among the highest in emerging market economies. The possibility of changing terms of borrowing from fixed to floating interest rates could thus be beneficial for the corporates. The measures for corporate debt restructuring that have already been initiated need to be accelerated. The development of a liquid market for impaired assets now enthused by the new Act for securitisation and restructuring would facilitate their restructuring or write-off.

8.19 Furthermore, the manufacturing sector is facing internal and external competition due to withdrawal of quantitative restrictions on imports and the continuing reduction in peak tariff levels. In order to meet these challenges, there has to be industrial restructuring through mergers and acquisitions, amalgamation, takeovers and technical collaborations. This would achieve quicker investment reallocation geared towards activities with comparative advantage. The process of corporate restructuring has so far been confined to a few segments, such as basic goods, and has not permeated to other major segments.

8.20 The ongoing process of restructuring would be strengthened if the pace of institutional reforms is accelerated. This would entail institution of more rapid bankruptcy procedures, flexibility in labour use, and reforms in urban land ceiling and small-scale reservation policies. Putting into place an effective social security mechanism and a programme for retraining/re-deployment of labour is a necessary condition for removal of the rigidities in the labour market. Contextually, benchmarking domestic labour laws with other Asian and similar emerging economies may be advantageous in improving the operating environment for industry. The capital market would also have to be made pro-active to facilitate industrial restructuring. Judicial reform and creation of an economic regulatory structure would contribute to efficient restructuring and closure, concomitant with the development of a market for distressed assets. Legislative measures have been initiated to remove the regulatory/judicial hassles inhibiting restructuring and to remove the rigidities in the labour market. The recent enactment providing for securitisation of assets and steps towards improvements in bankruptcy law may also facilitate industrial restructuring.

8.21 The continued reservation of small-scale industries (SSI) after the removal of quantitative restrictions on imports is a stark anomaly (Mohan, 2002). This policy prohibits large Indian firms from manufacturing reserved SSI items domestically, which in any case can be freely imported from large foreign producers. Most of the SSI areas have high export potential, if economies of large-scale production are properly reaped*. The process of SSI dereservation currently underway is, thus, a step in the right direction and needs to be accelerated to foster scale economies, enhance efficiency and promote competitiveness. Firms, which preferred to remain stunted in order to benefit from the policy of SSIs, are expected to upgrade in size and technology in the wake of dereservation. Dereservation would, however, have to be complemented by provision of finance and technical assistance, which requires banks to upgrade credit assessment capabilities to avoid the problem of adverse selection. This policy would also promote a symbiosis between large and small firms in terms of ancillarisation – as experienced in the East Asian countries.

8.22 Acceleration in industrial growth to double digit levels is essential for the achievement of 8 per cent GDP growth as targeted in the Tenth Five Year Plan. The removal of the remaining rigidities in the industrial sector would not only regenerate the required production growth but also promote much greater industrial employment.

Services and Infrastructure

8.23 As mentioned earlier, much of the growth momentum during the reform process came from services. The reform process in the services sector was integral to macroeconomic reforms, particularly to the structural reforms in the industrial sector. Apart from facilitating the supply response in the private sector, the reforms aimed at improving the efficiency in delivery of services by imparting market competition, thereby enhancing productivity of other sectors.

8.24 The improved growth performance witnessed across most sections of the services sector, bears testimony to the relative success of reforms in this segment. Illustratively, the positive outcome of financial sector reforms was reflected in the expanding share of finance, insurance and business services in the value added from services sector. Another area that has witnessed marked improvement is that of telecommunication services. Regulatory reforms and increased competition through private sector participation have resulted in a sharp increase in tele-density, reducing the demand-supply gap and unit cost along with improvement in quality of services offered, leading to higher value added growth.

8.25 Despite the current robust growth of the services sector, there is concern regarding medium-term growth sustainability of this sector given its strong linkages with commodity producing sectors and the large share of public administration and defence (PAD). The share of PAD in services has not witnessed any significant decline. Since such services do not directly add to consumer welfare, there is a need for furthering fiscal reforms aimed at pruning unnecessary Government expenditure while promoting greater expenditure in the provision of necessary public goods.

8.26 The growing infrastructure constraint, which dampens the supply response of the economy, highlights the inadequacy of structural reforms in this sector of the economy primarily relating to regulatory issues, pricing/user charges, cross subsidy and public-private partnership. A worrisome feature has been the declining trend in potential growth in output for a number of basic physical infrastructure services such as cargo handling and freight loading. The rates of return from infrastructure services extended by the Government continues to be low constraining the ability to generate internal resources for investment. A carefully calibrated policy package with emphasis on contestability, enforceable contracts, development of markets for long-term debt instruments, proper pricing of infrastructure services, and above all, transparent and non-discriminatory rules needs to be designed as a part of the next phase of reforms.

8.27 The higher cost of operations of certain services such as power, railways and shipment has spilled over to the manufacturing sector in the form of high input costs. The industrial sector continues to suffer from unstable power supply and high unit costs. The distribution of power could be privatised to help reduce losses arising out of transmission and distribution. Privatisation would, however, be contingent on finding a solution to the issue of outstanding

dues of State Electricity Boards (SEBs) and imposition of realistic economic tariffs. The signing of the tripartite agreement relating to the one time settlement of SEBs' past dues is a step in the right direction.

8.28 The operating ratio of the Railways remains high due to the persistence of distortionary pricing of railway services, thus, constraining its ability to release resources for Plan outlay. The restructuring of the Railway services becomes crucial keeping in view the increasing competition from roadways that would get intensified after the completion of the Golden Quadrilateral network. Railways need to operate on commercial lines so that the resources can be generated on a self-sustaining basis ensuring passenger safety as well as technological upgradation. Policy focus, thus, needs to be accorded towards corporatisation of Railways, rationalisation of freight rates, modernisation of rail services and development of commercially viable projects with public-private joint ventures. In case of ports, although some progress has been made towards private sector participation with a view to improving the turn-around period of cargo, the slow pace continues to act as a constraint to trade efficiency.

8.29 The process of convergence in the area of telecommunications and Information Technology (IT) needs to be expedited to enable rapid growth and to provide more efficient and cheaper services to users. In the emerging area of information technology, the hardware segment is still not competitive; consequently, there has been poor penetration in terms of information technology applications, infrastructure and services beyond urban areas. This explains a relatively low share of revenue from the domestic market for the software firms. Therefore, the development of communications infrastructure across the country, along with institutional reforms relating to legal and regulatory issues for e-commerce transactions, needs attention. India has labour cost advantage in this sector which is likely to exist for the next 15 to 20 years. Some key issues, however, need to be addressed for the promotion and further growth of the IT sector. These issues are: potential scarcity of talent due to migration of highly skilled labour, high telecom rates and lack of ready infrastructure. Larger lead time in commissioning telecom services and lack of a formal platform to interact with potential players are some of the challenges which need to be addressed to maintain India's comparative advantage against its competitors like Ireland and China. Issues emerging from the General Agreement on Trade in Services (GATS), particularly on the business process outsourcing and temporary movement of professionals, need also to be carefully negotiated to sustain the export potential of this sector.

8.30 Another dimension of the infrastructure projects is the time and cost overruns in the implementation of public sector projects. Time bound clearances at different stages and effective inter-agency coordination would cut down time and cost escalation considerably. Furthermore, monitoring and evaluation systems must be strengthened and the implementing agencies must be made accountable for non-adherence to the plan of work.

Labour Market

8.31 A smooth and frictionless labour market accompanied by a safety net is a necessary condition for maximising growth and welfare. Reforms have been hesitant in this important segment of the factor market resulting in a limited role of market forces in determining the demand for labour. In India labour legislations are largely responsible for the rigidities in the labour market that have prevented the restructuring or closure of several non-viable sick industries and redeployment of factors of production to the growing sectors of the economy.

Prohibition of retrenchment and closure of industrial units employing more than 100 workers (without Government permission) has led to discriminatory practices like: (i) existence of more capital intensive technologies not related to relative factor prices; (ii) setting up of multiple units negating economies of scale; and (iii) reliance on temporary labour preventing skill formation. Fresh investment, including foreign direct investment has been a casualty, particularly in labour intensive sectors. Ironically, such labour protection measures have contributed to the slow growth of industrial investment and employment.

8.32 Reforms are also vital in respect of contract labour. By preventing unbundling of production and its distribution and contracting out of services, the Contract Labour (Regulation and Abolition) Act, 1970 is not in synchronisation with the objective of inculcating flexibility in labour market to maximise efficiency and promote growth. That the necessity of amending these legislations has been recognised by the Government is reflected in policy announcements that have been made, particularly in the Union Budget speech of 2001-02.

8.33 In order to accelerate the process of industrial restructuring, several steps are warranted in respect of labour laws. Keeping with the global trend, the requirement of prior permission for closure of a unit may be waived and voluntary retirement schemes (VRS) can be made more attractive. Concomitantly, institutes for imparting technical skills to displaced workers can be established and a safety net can be set up by levying a cess on the corporate sector supplemented by budgetary support, and the floor for retrenchment could be raised to units employing at least 1000 workers as proposed in the Union Budget, 2001-02. As recommended by the Prime Minister's Economic Advisory Council, the Contract Labour Act should be replaced by an Act, which recognises that outsourcing of services is a normal activity. Regarding public sector, the more challenging tasks would be setting up a fund that creates annuities to finance VRS, workers' retraining and public sector restructuring.

Fiscal Policy

8.34 The fiscal system prevalent in the beginning of the 1990s was characterised by a sustained high fiscal deficit and mounting debt accumulation giving rise to inflation, financial repression, and overall deterioration in the macroeconomic fundamentals of the economy. This eventually spilled over to the external sector reflected in an enlarged balance of payments deficit. As such, fiscal correction and consolidation constituted the crucial agenda of the macroeconomic reforms initiated in 1991. The primary objective of the fiscal reforms was to restore fiscal balance by reducing the size of deficit and debt in relation to GDP, while increasing the spending on investment and infrastructure to provide momentum to the growth process.

8.35 The fiscal reforms in India were initiated in three major interrelated areas: (i) the restoration of fiscal balance; (ii) restructuring of the public sector; and (iii) strengthening of fiscal-monetary coordination. The strategy for restoring fiscal balance comprised a mix of tax and non-tax reforms, expenditure management and institutional reforms while public sector restructuring mainly involved a preference for divestment of Government ownership. The process of fiscal-monetary coordination encompassed deregulation of the financial system, elimination of automatic monetisation, and reduction in pre-emption of institutional resources by the Government. At the sub-national level, initiatives at fiscal adjustment were pursued in the context of deterioration in Government finances, which exacerbated in the latter half of the 1990s. More recently, States' efforts were also complemented by reform-linked Central

assistance along with adjustment programmes funded by multilateral agencies.

8.36 The fiscal performance during the reform period after the initial success has been characterised by a reversal since 1996-97. Both debt and deficit indicators are rising and are currently higher than the average for the 1980s. The combined Centre and State fiscal deficit is among the highest for all countries in the world and much higher than that recommended by the Eleventh Finance Commission. The reversal in fiscal consolidation originated in mounting revenue deficits, which have grown in size during the reform period. The rise in revenue imbalances was contributed by a persistent fall in tax buoyancy manifested in a decelerating tax-GDP ratio and downward rigidity in current expenditures due to growth in committed expenses, such as interest payments, subsidies and wages and salaries. The slow progress of the restructuring of PSUs also added to the deterioration in Government finances. This has affected the quality of expenditure, since pre-emption of high-cost borrowed funds for Government's consumption expenditure tends to crowd out public investment in productive sectors.

8.37 These developments necessitate further strengthening of fiscal consolidation as a part of the next phase of reforms to address the inherent limitations in the fiscal system. Dissaving arising from the revenue deficit of the Government not only reduces the overall saving and investment capacity of the economy, but also results in a continuous fall in the share of capital expenditure, which impacts investment in the infrastructure sector thereby threatening the growth potential of the economy. The phased elimination of revenue deficit of the Government ought to receive focused attention. Domestic saving could be increased by turning around public sector dissaving to a positive rate of at least 2 per cent of GDP. This will help in making feasible the growth target of 8 per cent set in the Tenth Five Year Plan by enabling an investment rate of around 32 per cent (from the present level of around 24-25 per cent of GDP). The two-pronged strategy in this direction is to arrest the growth in consumption expenditure on the one hand and to step up the tax-GDP ratio on the other. Prioritisation of expenditure is necessary in the process of containment of expenditure. In particular, subsidies could be pruned further and Government administrative machinery could be streamlined and downsized. A reduction in fiscal deficit will also progressively reduce the debt service burden thereby releasing expenditures for public goods provision, at the same level of overall expenditure. Efforts to step up the tax-GDP ratio should be through rationalisation of the tax structure, widening of tax base by phased reduction in tax breaks/ exemptions and bringing more and more services within the tax net.

8.38 Deterioration of finances during the latter part of the 1990s was much sharper for the States than for the Central Government. Although the growth in revenue of the States and the Central Government were comparable, a steeper rise in expenditure in the case of States resulted in their accounting for more than 50 per cent of the rise in fiscal deficit of the combined Government during 1996-97 to 2001-02. A major bane of State finances is the poor performance of State public sector undertakings, particularly the SEBs and State Road Transport Undertakings (SRTUs). An empirical exercise undertaken in this Report revealed that interest payments, sluggishness in Central transfers (arising from lower Central Government revenues), and low user charges leading to low returns on Government investments have been the prominent determinants of States' fiscal deficit. Restoration of revenue balance at the State level, therefore, would require raising user charges, overhauling tax collection machinery to achieve better tax compliance, raising returns on Government investment in PSUs through appropriate pricing

policies, eliminating implicit subsidies and lowering burden on fisc through phasing out of unviable public sector units. The introduction of Value Added Tax (VAT) should eliminate the practice of competitive tax concessions, which has seriously dampened the tax buoyancy across States.

8.39 The issue of growing public debt is another area of serious concern and it has a close bearing on the sustainability of fiscal policy. An assessment of the public debt in terms of both the 'accounting approach' and the 'present value constraint approach' indicates that continuation of current fiscal stance could make public debt of both Central and State Governments unsustainable unless corrective measures are undertaken to rein in fiscal deterioration. The persistent rise in interest payments particularly in the 1990s, has been a key factor for widening of fiscal deficit and consequent steep rise in public debt. The proposal to swap States' outstanding liabilities to Central Government on account of small savings could make a major dent in the growth of interest payments. For the Central Government, aggressive restructuring and divestment in unviable public sector units could bring in sizeable resources to redeem a part of outstanding liabilities and consequent reduction in interest payments.

8.40 The policy initiatives undertaken for the development of the government securities market, phasing out of automatic monetisation and reduction in pre-emption of institutional resources have provided a level-playing field to the private investor. The widening fiscal gap, however, could hamper the maintenance of the soft interest rate regime, which is vital in the context of the revival of economic activity.

In such an eventuality, it would not only crowd out private investment, but would also make public debt highly unsustainable given the level of returns on Government investments. Adoption of rules based fiscal policies could facilitate the path for durable fiscal consolidation through mandatory fiscal discipline. Speedy implementation of the provisions of the proposed Fiscal Responsibility and Budget Management (FRBM) Bill is critical for achieving the goal of ensuring inter-generational equity in fiscal management and long-term macroeconomic stability. It should not only help in attaining sustainability, but should also enhance the level of accountability and transparency in fiscal operations of the Central Government. Similarly, efforts should also be initiated at the sub-national level towards rule based fiscal policies for long-term fiscal sustainability.

Monetary Policy

8.41 The conduct of monetary policy during the 1990s was geared to supporting the overall economic reforms with a view to creating a competitive environment as a means of improving productivity and efficiency and ensuring macroeconomic stability. While the twin objectives of monetary policy remained the pursuit of price stability and ensuring credit availability for growth, the operating procedure of monetary policy underwent significant changes in response to the challenges of financial liberalisation. This also entailed reforms in the monetary and fiscal interface in order to ease the fiscal constraint. This process was well supported by structural measures, through the dismantling of administered interest rates and the deregulation of credit markets. Given the changes in the monetary landscape, the process of adjustment has been reasonably smooth. The Reserve Bank was successful in achieving the objective of a phased scaling down of statutory pre-emptions. An important macroeconomic development was the sharp decline in the inflation rate during the second half of the 1990s attributable to better

monetary management as well as generally favourable supply side factors. An empirical assessment of the monetary policy transmission mechanism suggests that the output and inflation variations, particularly in the second half of the 1990s largely emanated from non-monetary factors and the contribution of the monetary policy shocks has further declined during the 1990s as compared with the 1980s.

8.42 Monetary management increasingly assumed a market orientation. Switch over to indirect instruments of monetary control was consistent with the objective of rekindling the process of price discovery in the financial markets for the purpose of efficient resource allocation. Besides, the opening up of the economy required the Reserve Bank to counterbalance the domestic and the external sources of monetisation in order to maintain stable monetary conditions. The Reserve Bank gradually put in place a liquidity management framework in which monetary conditions are harnessed to the final objectives through a range of instruments, such as open market (including repo) operations and changes in reserve requirements, reinforced by interest rate signals through the Bank Rate and the repo rates. In the process, the liquidity adjustment facility (LAF) has emerged as the principal operating instrument of monetary policy. Besides, the growing macroeconomic complexities required a shift from the earlier monetary targeting framework to a multiple indicator approach in which a host of macroeconomic variables are now monitored for the purpose of monetary policy formulation.

8.43 In addition, the Reserve Bank, like many other central banks in emerging market economies, has had to increasingly contend with maintaining financial stability. Besides, the Reserve Bank's role as manager of public debt also implies that the internal debt management function gets inextricably mixed with the monetary management function. In view of the limited number of instruments, the Reserve Bank has to prioritise its objectives given the circumstances. This constrains the degree of flexibility available to monetary policy in a complex macroeconomic environment.

8.44 Fiscal dominance continues to be the critical issue. Capital inflows coupled with weak credit demand enabled the Reserve Bank to trade surpluses of the banking system with the deficits on the Government account and thereby ease the fiscal constraint on monetary policy. In the process, net domestic assets of the Reserve Bank have been shrinking and this could impose limits on the scope for sterilisation in the future. At the same time, in view of the burgeoning fiscal deficit, the situation could change very quickly in case there is a pick-up in industrial activity or if capital flows dry up, especially as banks continue to hold a large portfolio of government securities well beyond the statutory prescriptions. It is in this context that the need is sometimes felt to separate the internal debt and monetary management functions. At the same time, even if the Reserve Bank does not directly subscribe to market borrowings, the fiscal impact on bank liquidity would still constrain monetary policy. There is thus a limit to which a central bank can ease the fiscal constraint through liquidity management operations. The proposals advocated by the proposed FRBM legislation for reducing the role of the Reserve Bank in primary subscriptions and limiting the fiscal deficit, thus, assume particular significance.

8.45 The deregulation of interest rates and the evolution of inter-linked financial markets facilitated the gradual emergence of an interest rate channel of monetary policy transmission.

There is increasing evidence that the Reserve Bank is now able to effectively influence movements in short-term interest rates in the money markets and by extension, prices in the government securities markets. The pass through to the credit markets is, however, still very weak. The deposit and lending rates of scheduled commercial banks continue to be relatively sticky, largely reflecting structural constraints in the form of a large order of NPAs and the continuation of Government administered interest rates in small saving instruments. This had led to downward rigidity in real interest rates blunting the effectiveness of monetary policy. It may be mentioned here that this rigidity in the small savings rate has been partially addressed as the Union Budget, 2002-03 announced that the interest rate on small savings would be linked to the average annual yield on government securities in the secondary market. Corresponding adjustments in these rates have been announced in the Union Budget, 2003-04. To promote flexibility in interest rates, issues such as asset quality of banks, adoption of floating deposit rates and strengthening of asset-liability and risk management by banks, and rigidities in the interest rates of competing assets need to be addressed.

8.46 Unlike in the past when bank balances with the Reserve Bank were largely governed by reserve requirements, the demand for bank reserves in the future, in the context of a declining cash reserve ratio (CRR), are likely to depend on banks' requirements in respect of settlement balances. Day-to-day monetary management would thus require a closer assessment of market liquidity. It is in this connection that the Reserve Bank has initiated a process of liquidity forecasting. While the gradual institution of a real time gross settlement (RTGS) system would control *domino* risks of default, this is also likely to exert pressure on liquidity management.

8.47 The monetary policy framework has been shifting course throughout the 1990s. The breakdown of a stable relationship between money, output and prices as a result of financial innovations coupled with high inflation rates led to the adoption of an inflation targeting framework in many economies. While the pursuit of price stability could be a sound proposition in itself, there continue to be many constraints in the Indian economy, as in many other emerging market economies, which prevent the switch to an inflation-targeting framework. At the same time, it must be recognised that the current anti-inflationary stance was largely built in the backdrop of the high inflation of the 1980s. Since inflationary pressures have been subdued in the recent past, the coexistence of low inflation and low growth in the past two years poses a fresh challenge to the conduct of monetary policy.

Financial Sector

8.48 In line with the deregulation and liberalisation policies of the 1990s, financial sector reforms were undertaken in the early phase of reforms. The basic objectives of the reforms were to enhance stability and efficiency of the financial system. It was felt that directed allocation of resources during the pre-reform period, although in accordance with the Plan priorities, was not conducive to allocative efficiency, and the higher rate of growth of financial saving was not matched by a proportionate increase in the rate of growth. The recurrence of domestic banking crises in developed and developing economies alike during the 1980s, and the financial crises in a host of countries in the 1990s underscored the necessity of financial stability for sustained growth. It was recognised that a vibrant, resilient and competitive financial sector is vital for sustaining the reform process in the real sectors of the economy.

8.49 The most significant achievement of the financial sector reforms has been the marked

improvement in the financial health of the commercial banking sector, in terms of asset quality, capital adequacy and profitability. Despite these improvements, the commercial banking sector continues to face several challenges. First, a major concern for the banking system has been the high cost and low productivity as reflected in relatively high spreads and cost of intermediation. An important challenge for the banking sector, therefore, remains in transforming itself to a more efficient, productive and competitive set up.

8.50 Second, although the capitalisation level of almost all banks operating in India is above the prescribed minimum levels, banks may face difficulties to maintain their capital levels in coming years. The capital requirement of banks is likely to increase with pick up in credit demand and the implementation of the New Capital Accord sometime in 2006, which has accorded greater emphasis on risk-sensitivity in credit allocation. Banks would need to consider these factors while estimating their capital requirements. Given depressed capital market conditions and banks' limited ability to generate sufficient funds internally, maintaining the capital position in line with the prescribed norms would be a major challenge.

8.51 Third, commercial banks continue to face the problem of overhang of NPAs, attributable, *inter alia*, to systemic factors such as weak debt recovery mechanism, non-realisation of collateral and poor credit appraisal techniques. Policy measures have yielded mixed results. The recent enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 has increased the momentum for the recovery of NPAs. However, banks need to intensify their efforts to recover their overdues and prevent generation of fresh NPAs.

8.52 Fourth, in a regulated regime, risks were essentially compartmentalised with various categories of market and credit risks being managed separately. Increasingly, risk is viewed as multi-dimensional. To enable banks to cope with risks, the Reserve Bank has been engaged in preparing banks for pro-active risk management. Banks would need to establish technical systems and management processes necessary not only to identify risks associated with their activities, but also to effectively measure, monitor and control them.

8.53 Fifth, it is important that financial institutions possess means and measures of corporate governance. The quality of corporate governance would become critical as competition intensifies, ownership is diversified and banks strive to retain their client base. Banks would be required to further improve their internal management systems in terms of housekeeping, audit practices, asset-liability management and systems management to attain international best practice levels.

8.54 Sixth, a sound and well-diversified banking system envisages development of a banking sector with a diverse array of well-capitalised and healthy banks. As the dynamics of reforms gathers momentum, the coming years are likely to witness consolidation in the banking sector. Such consolidation will be driven by market forces in an enabling environment, which brings together willing institutions. A related issue is that of ownership of banks. Public sector banks (PSBs) continue to dominate the Indian banking sector and progressively the ownership needs to be diversified to make them more amenable to market discipline and reduce the possibility of regulatory forbearance.

8.55 Finally, bank lending tends to be pro-cyclical, while the level of NPAs tends to behave in a counter-cyclical fashion. Consequently, in a downturn, as the condition of borrowers deteriorates, they tend to be downgraded by banks with the consequence that extra provisioning has to be set aside, potentially exacerbating the capital shortage. Such behaviour on the part of banks tends to accentuate cyclical fluctuations. In these circumstances, dynamic or forward-looking provisioning by banks may be useful for circumventing such outcome.

8.56 With the phased withdrawal of Government from direct intervention in the financial sector and gradual divestment of Government ownership in major financial institutions, the importance of deposit insurance arrangements has increased in the context of attainment of financial stability. Introduction of risk-based deposit insurance premium, separation of deposit insurance arrangements for co-operative and commercial banks and introduction of co-insurance, among others, would help foster greater systemic stability as also provide a safety net for depositors.

8.57 In co-operative banks, the impact of reforms appears to be limited, if assessed in terms of stability and efficiency parameters. One of the reasons for this appears to be delay in the initiation of reforms and the slow paced reform in the sector. Duality of control has also posed concern over the sharing of responsibilities among the regulatory and supervisory authorities. The current duality of control over co-operative banks by the Reserve Bank and the respective State Governments is impeding effective supervision of such entities, which needs to be resolved.

8.58 In the changed operating environment, development finance institutions (DFIs), which have traditionally been among the main sources of long-term finance for the corporate sector in India, are finding it increasingly difficult to maintain their viability. In view of this, the future role of these DFIs needs to be addressed urgently as the alternative source of long-term funds has not developed. As some DFIs convert themselves into banks or NBFCs, an important source of long-term funds would dry up. Thus, there is a concern regarding the vacuum which would be created by the withdrawal of DFIs from the scene. Although banks have entered the domain of term-lending, there are limits on the extent to which commercial banks may be able to fill this vacuum. The shift from fixed to flexible interest rate regime, development of instruments for hedging interest rate risk, and effectiveness of timely resolution of NPA-related problems would influence the flow of funds from banks for meeting long-term financing requirements. Banks alone, however, may not be able to compensate the decline in long-term funds by DFIs to the corporate sector. To fill the gap, the development of a private corporate debt market is of crucial importance. The development of a benchmark in the fixed securities market and development of secondary market for corporate debt would also stimulate banks' investment in corporate securities.

8.59 In the case of mutual funds, while reforms have been successful in creating a competitive environment, the growth of mutual funds slowed down sharply partly due to depressed market conditions and partly due to the problems faced by the Unit Trust of India. Reforms in the insurance sector, which are of recent origin, have also been successful in enhancing competition even as the impact of increased competition on the insurance penetration is yet to be felt.

8.60 Financial sector reforms have been successful in bringing significant improvements in various market segments by effecting regulatory and legal changes, building up of institutional infrastructure, constant fine-tuning in market microstructure and substantial upgradation of technological infrastructure. Efficient, stable and healthy financial markets constitute the bedrock for successful conduct of monetary policy; hence, improving the effectiveness of the transmission channel of monetary policy necessitated significant reforms in the money and government securities markets. Facilitating integration of domestic financial markets was the other major objective of financial market reforms.

8.61 Financial market reforms have helped in improving the price discovery in the primary market, while the secondary markets have attained greater depth and liquidity. The number of instruments and participants has also increased. The capital market has become a safer place for investors as various risks involved at various stages of trading and settlement have been either completely eliminated or reduced considerably. Liquidity in the stock market has improved considerably. The government securities market has witnessed a transformation from a captive bank-dominated market to an active debt market operating at market related/determined interest rates. Among the financial market segments, the linkages among the money, government securities and foreign exchange markets have been established and are growing. The presence of foreign institutional investors has strengthened the integration between the domestic and international capital markets.

8.62 The Reserve Bank's short-term liquidity management is centred around the LAF operations through repo/reverse repo transactions. However, certain impediments need to be overcome for the smooth operation of LAF. These include the presence of non-bank players in the call market and skewed distribution of liquidity among market players. Further development of the term money market would help in removing the segmentation in the yield curve. This is crucial for effectiveness of monetary policy transmission. Placing limits on banks' exposure to call money market, making call money market a purely inter-bank market, encouraging development of the collateralised repo market, adherence to prudential asset-liability and risk management guidelines, and on-line connectivity between major bank branches are expected to preserve the integrity of financial markets and facilitate emergence of term money/repo markets in the near future. Significant achievements have been made through the operationalisation of the Clearing Corporation of India Ltd. (CCIL) and the Negotiated Dealing System (NDS). The wider accessibility of NDS to facilitate the development of a repo market in a risk free environment for settlement would need to be expedited.

8.63 Future developments in the Government securities market hinge on legislative changes consistent with modern technology and market practices. Other measures include the introduction of an RTGS system, integration of the payment and settlement systems for government securities, standardisation of practices with regard to manner of quotes, conclusion of deals and code of best practices for repo transactions and retailing of government securities. The recently proposed introduction of trading in government securities through a nation-wide, anonymous, order-driven, screen-based trading system of the stock exchanges, in the same manner in which trading takes place in equities, would further enhance the operational and informational efficiency of the market as well as its transparency, depth and liquidity, thereby providing for a country-wide retail investor base.

8.64 Derivatives can play an important role in risk mitigation. There has been a substantial increase in Interest Rate Swaps (IRS)/Forward Rate Agreements (FRA) transactions in 2002. With the increased popularity of the derivatives, a range of possibilities for efficient pricing, hedging and managing of interest rate risks will open up. These would raise new issues like counterparty risks and liquidity risks. For optimising the capital charges, the clearing and settlement of contracts could increasingly be through a centralised counterparty. It may, however, be noted that derivatives market is in an evolving stage in India. A cautious, gradual and sequenced approach to introduction of derivatives instruments to avoid pitfalls is in order. Like derivatives, introduction of floating rate bonds can promote effective management of balance sheet risks when interest rate outlook is uncertain.

8.65 Depth and liquidity in the spot as well as forward segments in the foreign exchange markets need to be enhanced further. A way to address these concerns lies in the further development of the money market as well as in assumption of the role of 'market makers' by large public sector banks who handle the major portion of the export-import transactions. The pre-conditions for the pick-up of activity in forex derivatives include sequentially, the development of (i) a deep and liquid inter-bank term money market, (ii) a liquid forward dollar-rupee market, and (iii) rupee-based derivatives. Expeditious development of these market segments would remove the irritants in the healthy development of the foreign exchange market. In the light of the experience of the East Asian crisis, the movement would need to be 'gradual' as the 'big-bang' approach could have adverse repercussions for the exchange rate regime, foreign exchange reserves, BoP situation and the overall growth prospects of the economy.

8.66 Although the capital market has made significant strides in information acquisition, processing and dissemination, there is little evidence that it is now processing the information more efficiently than before reforms. Both, the primary market for private debt (with preponderance of privately placed debt issues) and the secondary market are lagging behind the equity markets in terms of transparency, thus adversely affecting the process of price discovery. Preponderance of the private placement market can potentially strip the market of its ability to discipline issuers and thereby enhance systemic risk. Not all privately placed issues are listed. As a result, investors cannot signal their changing evaluation of the business prospects of the issuers. Some recent regulatory initiatives have been taken to contain risks. In addition, norms for corporate disclosure would also require to be strengthened that would enable investors to take informed decisions as well as to promote transparency. Measures to revive the public issues segment of the primary market could also be contemplated.

External Sector

8.67 External sector reforms were initially conditioned by the need to correct the deficiencies that led to the payments imbalance of 1991. Inappropriate exchange rate regime, unsustainable current account deficit and a rise in short-term debt in relation to the official reserves were the key factors contributing to the crisis. The swift transition to a market determined exchange rate regime was felt necessary to create an important pre-condition to deal with the uncertain responses to reforms introduced in other spheres of the external sector. These reforms include: dismantling of trade restrictions alongwith tariff rationalisation, moving in the direction of current account convertibility, liberal inflows of private capital, removal of restrictions on all

inflow-related outflows and gradual liberalisation of restrictions on outflows involving residents. Simultaneously, priority was accorded to make available better quality products at globally competitive prices, and provide greater freedom of choice to residents to undertake current transactions on a global scale.

8.68 The strength and resilience of the external sector has been the hallmark of India's macroeconomic environment during the last decade. Amidst a series of crises in several emerging markets, India successfully avoided any crisis while consistently pursuing a process of opening up to benefit from larger access to global markets, private capital, foreign technology and global competition. At every stage of major policy reforms - from the switchover to a market determined exchange rate regime in March 1993 to the recent phasing out of quantitative restrictions on imports - there were apprehensions in certain quarters that the economy may become more vulnerable to crises as a result of reforms. However, in the pursuit of a prudent capital account liberalisation, the timing, pacing and sequencing of reforms seemed to have been influenced by both the capability of the economy to withstand shocks in terms of its ability to meet initial pre-conditions, and the need for avoiding policy reversals. On account of this gradualist approach to the reform process, the external sector acquired strength and greater stability. This is exemplified by modest deficit/surplus in the current account, strong capital flows in relation to the financing-gap and absorptive capacity of the economy, orderly exchange rate, comfortable foreign exchange reserves and sustainable external debt.

8.69 The success of India's exchange rate policy in managing volatility without a fixed exchange rate target has been reflected in maintaining the exchange rate of the Rupee at a realistic level during the reform period. Recent international research on viable exchange rate strategies in emerging markets has lent considerable support to the exchange rate policy followed by India.

8.70 The policy of emphasising non-debt creating flows and de-emphasising debt creating flows and short-term debt has been reflected in the consolidation of external debt. The accretion to higher level of foreign exchange reserves brought about primarily by non-debt creating capital flows has ensured sustainability of the external debt. These achievements not only led India to be classified as a "less indebted country" by the World Bank but also enhanced the credibility of the Indian economy in international fora.

8.71 In terms of reserve adequacy indicators, India is among the leading reserve holding countries in the world, which has encouraged the authorities to utilise reserves to prepay high cost debt. The high level of foreign exchange reserves has not only provided strength to the Indian economy by fostering stability to the exchange rate, sustainability to the external debt and credibility to the capital account liberalisation process, but also provided enormous support against unforeseen external shocks.

8.72 The reserve management policy coupled with the exchange rate management and monetary policy pursued by the Reserve Bank has created an atmosphere of a soft interest rate regime which is conducive to higher economic growth. In addition, the recent policy initiatives undertaken by the Reserve Bank and the Central Government have created an investment atmosphere where foreign investment supplements domestic investment, which in a medium term perspective, would ensure a growth trajectory consistent with the Tenth Five Year Plan.

8.73 Notwithstanding the favourable developments in the external sector, there are several short-run and medium-run policy challenges. In the short-run, the major challenge comes from the surge in capital inflows and there is a need for fully channelling these flows into the productive activities. Assuming that the short run absorptive capacity of the economy is sticky but can be augmented in the medium-term, there are at least four policy options to deal with excess market supply. The first option is to allow the Rupee to appreciate, which by increasing imports and reducing exports would allow capital inflows to be utilised. This, however, raises the issue of sustainability of balance of payments, particularly, in view of the synchronised current global economic slowdown that has implications for the export prospects of developing countries. Under these circumstances of the BoP turning unsustainable due to weak export performance, a change in market expectations could induce reversal of capital flows and can trigger a crisis. The second alternative is to tighten regulation of capital inflows, which needs to be avoided keeping in view the medium-term larger financing requirements for growth as envisaged in the Tenth Five Year Plan. The third alternative is to hasten the pace of liberalisation of restrictions on capital outflows, which would be justifiable only when all the preconditions to liberalisation are met. The fourth option is to absorb capital inflows in the form of higher foreign exchange reserves.

8.74 In the medium-run, the policy challenges primarily arise from the need to meet both the Tenth Plan growth targets and the export targets envisaged by the Government. Accordingly, the current account deficit (CAD) is targeted at a higher average of about 2.8 per cent of GDP consistent with the Tenth Plan growth target. Such widening of the current account deficit will only be achieved if there is a much higher import growth than experienced in recent years. Such change will take place only if there is a resurgence of both public and private sector investment. A 12 per cent compound annual growth in exports is also envisaged in the Medium Term Export Strategy (2002-03 to 2006-07) and this would have to be achieved and sustained if India were to raise its share in world exports from 0.7 per cent at present to 1 per cent over the next five years. This is perceived as a necessary condition for the sustainability of balance of payments; else, there could be a significant depletion of reserves, which may have adverse consequences unless the exchange rate depreciates substantially. The important challenge, thus, would be to boost export growth, along with higher import, attract larger capital inflows to finance the planned level of CAD and maintain comfortable reserves consistent with the requirements of a growing and increasingly integrated economy. As regards the exchange rate policy, the preferred option would be to continue with the present policy approach of managing volatility with no fixed rate target, which has stood the test of time.

8.75 Despite the success of the policy efforts pursued in the external sector, there remain a few areas of challenge requiring sustained efforts. India's tariff rates continue to be high relative to South East Asian levels. The Government has, however, already indicated a move in tariffs comparable to the East Asian levels by 2004-05. The customs procedures, though somewhat simplified, need further rationalisation. The growth in merchandise exports needs to be leveraged further. A robust growth in exports alongwith import growth would impart efficiency gains to the economy. India has taken an active role in the Doha Development Agenda but collective efforts would be required from all developing countries in order to benefit from the negotiations. In addition, larger financing requirements for growth as envisaged in the Tenth Five Year Plan underline the need for further concerted efforts in the direction of attracting higher FDI.

Therefore, along with the liberalisation of both, inward and outward capital flows, a more focused approach should be pursued for attracting higher FDI flows which is important for achieving higher economic growth.

8.76 Despite a relatively lower degree of openness, synchronisation of global business cycles has emerged as a policy concern, particularly because a global slowdown in economic activity seems to influence the domestic investment climate more than the actual volume of trade and capital flows. The current phase of global slowdown that started in mid-2000 suggests a weaker and delayed global recovery than was initially anticipated. Uncertain global prospects would also have a bearing on the course of future reforms in the external sector.

Conclusion

8.77 India's experience with reforms has reflected the pursuit of an open-ended, eclectic and pragmatic approach on questions of economic policy. The issue of the supremacy of markets over Government and of the private sector over the public sector is now in the realm of ideology without practical relevance. Recognising that both market and State failures exist, the practical issue is about harnessing the productive resources available in each. This could be done on the basis of identification of the dynamic comparative advantage that the public and the private sectors have in the various segments of the economy. A policy of entry and exit and economic restructuring on lines of competitiveness needs to be put in place. There is also the practical issue of reinforcing the markets by providing a wider menu of instruments. This would need to be backed by a stronger legal and institutional system, which is a necessary pre-condition for successful transition to a market oriented economy. In this regard, the State has to establish the regulatory framework that minimises the regulatory burden on the market players and hindrance to the free-play of market forces, for the ultimate objectives of growth and development with financial stability. As observed by Jalan (1992), 'The historical lesson is that most of the successful cases of development are those which have managed to combine the virtues of conflicting paradigms rather than rely exclusively on a single-set of pre-ordained theoretically right policies'. The challenge today is to take the reforms further by addressing the remaining agenda. Policy reforms would need to focus more sharply on the gaps mentioned in this Report, specially in the areas of real and fiscal sectors.

* The industrial clusters in SSI identified by United Nations Industrial Development Organisation (UNIDO) reveal that 72 clusters have high potential for exports, 47 have medium and only 19 have low export potential.