<u>Economic Reforms and Manufacturing Sector Grow: Need for Reconfiguring the Industrialisation Model</u>

Introduction

In the time period after reforms (1991–2016), the manufacturing (or industrial) sector has grown annually between 7% and 8%. The growth rate after the reforms is higher than the time period before it on an average, but it is roughly the same as in the 1980s, when the early reforms were initiated.

India's share in global merchandise trade has moved up from nearly 0.5% in 2000 to 1.5% by 2015, and the share of services exports rose from 1% to 3% during the same period. Industrial production has diversified with improvements in the quality and variety of goods produced with growing domestic competition. Yet, the manufacturing sector's share has stagnated at about 14%–15% of gross domestic product (GDP) after the reforms, in contrast to many Asian economies that have transformed their economy with a rising share of manufacturing in domestic output and global trade.

The comparison is even starker if we compare it with China. Around 1950, both the large Asian giants were roughly at the same level of industrialisation (or lack of it); if anything, India had an edge. By 2010, however, China became world's second largest manufacturing nation, and India ranked 10th, producing one-third of China's industrial output.

India initiated reform process in 1980s with delicensing and import liberalisation (that is, a switch from quotas to tariffs). Since 1990s we went for a clear departure from the state-led domestic-oriented, capital goods- focused, "heavy" industrialisation strategy, towards a market-friendly regime as part of the structural adjustment programme.

After independence the economic policies in India were inward looking with massive involvement of government in the secondary sector. The main elements of India's policy framework that hampered efficiency and growth until the 1970s, and somewhat less so during the 1980s as limited reforms began to be attempted, are as follows:

- Extensive bureaucratic controls over production, investment and trade via permit/licences
- Inward-looking trade and foreign investment policies;
- A substantial public sector, going well beyond the conventional confines of public utilities and infrastructure.

The reforms, though started with industry and trade, also resulted in integrating India with global financial markets in the last decade. With this India became prone to global economic cycles of boom and bust. The scope of public sector was reduced even in the areas concerning utilities and infrastructure by allowing private and foreign capital in these industries.

India surely experienced the boom during its Golden era from 2003 to 2008, to register an unprecedented annual economic growth of about 9%, to be counted as among the world's fastest growing large economies. If China came to be known as the world's factory, India was referred to as its back office (due to success in outsourcing activities).

But after the global financial crisis, as with the rest of world, India's boom went bust, with industrial deceleration, rising import dependence, and growing short-term capital inflows (or, simply, hot money) financing the balance of payments deficit.

So the important question we need to answer is that after a quarter century of market-oriented reforms, why did India fail to continue with growth accelerations (or catch up with) the Asian economies to confirm its reputation as a successful industrial nation with rising manufactured exports?

Perhaps, with booming services exports, India dreamt of skipping the industrialisation stage to be counted as the world's back office, with the help of its large "educated" English-speaking workforce, and ignoring the fact that jobs in services are skill intensive hence lack the scope for creating employment for the masses. And that reliance on outsourcing activities for growth in services makes us more dependent on advanced economies like US.

At the moment India is strategizing to reindustrialise and put its economy back into the growth momentum and trying to deal with its persistent economic backwardness (with half of its workforce still engaged in low productive agriculture, and over two-thirds of the population still living in villages) with bleak export prospects, and short term volatile capital inflows financing its external deficit.

The "Make in India" campaign intends to raise the manufacturing sector's domestic output to 25%. But, the real challenge apparently is to translate these high goals into actionable policies.

In this paper we want to lay out a broad framework of analysis for such an initiative.
This paper critically reviews industrial performance and policy after the reforms in 1991, and seeks to address the question of how to get over the economic stagnation.

Industrial Trends

Over the entire period of reforms (1991–2014), the manufacturing sector grew at an annual trend growth rate of about 7%. This 25-year period can be subdivided into three distinct phases: 1992–96, 1997–2003 and 2003–14.

The first phase represents the initial euphoria of reforms, with booming output and investment in the anticipation of a virtuous cycle of faster growth and exports. However, with the expectations of a boost in demand was not being realised, industrial growth decelerated. It coincided with the Asian financial crisis, bust of the dot-com bubble, and freezing of credit markets in the US in the early 2000s.

The period from 2003 to 2014 represents, the recent debt-led cycle of boom and bust, perhaps best illustrated by the trends in India's and global exports. After the global financial crash in 2008–09, fiscal and monetary stimulus domestically and capital inflows on account of quantitative easing (QE) in the advanced economies sustained economic growth until 2011–12 (as also in many emerging market economies), giving rise to a short-lived euphoria of emerging market economies (EMEs) getting "delinked" from the advanced economies.

The industrial growth scenario after 2014 remains unclear on account of unreliable data.
The turnaround in industrial and domestic output growth rates are not supported by the trends in (i) credit growth and (ii) capacity utilisation in industry.

Performance during the Boom and Bust

From 1991 to 2003, industrial performance was not particularly impressive. After the initial boom until 1996, there was a nine-year period of deceleration, when the output growth was buffeted by many shocks, such as the Asian financial crisis. However, the following cycle of boom and bust (2003–14) was significant in many respects.

Five years of India's dream run (2003–04 to 2007–08) were surely led by outsourcing services exports, but manufacturing growth matched the boom with a 10% annual growth rate. This was made possible by a steep rise in domestic savings, investment, and capital inflows, boosting the capital formation rate to close to 40% of GDP at the peak of the boom in 2008.

The growth rate recovered after the financial crisis in 2008–09, but at a slower rate of 7.3% per year in the following four years until 2011–12, and decelerated rapidly thereafter.

In this period from 2004–05 to 2013–14, consumer durable goods and capital goods (with each weighing about 8% in the IIP) grew close to 10% per year, while consumer non-durable goods (with a weight of 21%) grew the slowest at 4.2% per year. This was also the time when foreign firms and brand names came to dominate many markets, especially consumer durables and capital goods. The import to domestic output ratio went up quite sharply in most industries.

However, if indirect imports are included, the ratio would go up further. In the 2000s, two significant policies were initiated for industrialisation, namely, special economic zones (SEZs) and unfreezing of the land market for private industrial and infrastructure investment.

Until then, export processing zones were set up by the public sector, and land acquisition for infrastructure was their exclusive domain. When these activities were thrown open to private and foreign capital, the results were dramatic. The land market quickly got commercialised, with easy access to domestic and international capital, and with property development acquiring primacy over industrial use of land.

In practice, these policies—meant for promoting industrial exports and infrastructure—quickly became a means of acquiring scarce land, often with state support, from gullible farmers who sold their land cheap or were evicted with the state's connivance, giving rise to the term, "predatory growth". This resulted in widespread political and social agitations against such policies, contributing little by way of industrial output.

Competing Explanations for the Trends

How does one understand the foregoing account of industrial performance? Crucially, if permit–licence raj hampered industrial growth during the planning era, then why did industrial output and exports not take place after the reforms?

Economists who favour reforms argue that the reforms have not gone far enough or the agenda remains incomplete— with restrictions remaining on foreign direct investment (FDI) (especially in retail trade), labour market regulation (in the ability to hire and fire at will), full convertibility of capital, etc.

These arguments seem questionable because there is no clear theoretically valid and empirically sound association between pro-market reforms and growth. But we clearly need to critically examine the outcome of the liberalisation. And one related question in this regard is what has India's open-door policy for FDI led to?

In the last decade, the most significant variety of FDI inflow has been private equity (PE), venture capital (VC), and hedge funds (HF), which are, by definition, loosely regulated alternative investment funds that are part of shadow banking.

They are not even considered as FDI as they are not for the long-term. Quantitatively, the most important of these sources is PE funds, which, by definition, acquire existing assets and sell these after three–five years in the stock market after restructuring which hardly brings any benefit to the domestic economy. These are hardly the kind of foreign capital that India needs for getting technology and acquiring industrial capability. Economic implications of PE investment are that it is financing of domestic consumption using foreign debt, not productive investment.

The argument that labor market is very restrictive and hence holds back economic growth is seriously contested. India's largest machinery and construction firm reportedly laid off 14,000 workers of its workforce of during July–September 2016.It amply demonstrates that the “hire and fire” policy effectively rules the organised labour market today. But that also true that fired workers are temporary or contract workers who are not protected by labour laws.

But, the fact that such a large enterprise employs non-permanent workers in such large numbers only goes to show how the seemingly rigid laws do not apply to a growing segment of organised workers and that the laws really don’t matter. Hence, the contention that labour laws are holding up flexible and efficient use of labour simply does not hold water.

Currently, policymakers are using the “Ease of Doing Business” (EDB) as a measure of hurdles faced by entrepreneurs, and are busy trying to improve India’s global ranking to attract more foreign investment. This doubtful measure, both conceptually and practically, hardly explains the foreign investment inflows in developing countries.

The relationship between improved ranking and increased FDI is insignificant for the developing countries. But on average, countries that undertake large-scale reforms relative to other countries do not necessarily attract greater foreign direct investment inflows.

This means that we should look elsewhere for the reasons of the industrial stagnation. The answer perhaps lies in going for structural reforms and relaxing the long-term constraints on the economy such as less than satisfactory or poor agriculture performance after the reforms.

Moreover, despite gradual improvements, land productivity in agriculture continues to be a modest fraction of the global average. Further, lack of adequate public infrastructure investment (as capacity creation for power generation by proxy) seems to be holding back industrial growth.

At the moment, in the aftermath of the global financial crisis, Indian industry is suffering from excess capacity in major industries like steel, coal and machinery, as investment rates and exports have fallen. Fixed capital formation ratio, for instance, has fallen by almost 10 percentage points, from close to 40% of GDP in 2008. As the private corporate sector is mired in debt, and the banking sector is left holding non- performing assets, there is little option but to revive public investment to boost investment and domestic output.

Need for Reconfiguring Development State

State intervention during the planning era (1950–80) had many shortcomings. Yet, perhaps, the rush to open up markets after 1991 (under stressed macroeconomic conditions) seems to have hurt long-term industrial and trade prospects. So, there seems to be a need to rebalance the equation between the state and the market keeping in view the strategic considerations.

Faster manufacturing sector growth propels the rest of the economy. It acts like a positive externality in other sectors of the economy. So the need of the hour is an Industrial Policy at the national level to set the national goals and outline a broad framework where private sector can function without any hindrance. The government should restrict its role to be the facilitator of private sector. Government can contribute by relaxing infrastructural constraints and other institutional constraints in the economy. And it should intervene when there is a scope of market failure due to information imperfections. Moreover, the comparative Asian experience (starting with Japan to a contemporary account of China and Vietnam) offers powerful empirical arguments for industrial policy.

Three aspects of industrial and investment policies that seem to need careful attention are: (i) long-term finance, (ii) domestic research and development (R&D) efforts, and (iii) bilateral investment and trade treaties.

India seems to have a disadvantage vis-à Vis its trading partners, especially with respect to China in all these policies.

During financial liberalisation, India turned its development financial institutions (DFIs)—such as IDBI (the Industrial Development Bank of India) and ICICI (Industrial Credit and Investment Corporation of India)—into commercial banks, resulting in shortening of loan maturity, thus constraining capital-intensive manufacturing and infrastructure financing.

The domestic debt market was expected to fill the vacuum, and that has not happened.
In response, large firms were allowed to borrow internationally even for investments in the non-traded goods sector, leading to currency and maturity mismatches, thus raising potential financial instability.

China, which is still not officially granted the status of a market economy, is known to use cheap credit (including trade credit) as an instrument for penetrating international markets, especially in project exports. Indian firms are perhaps unable to match the Chinese firms' commercial terms, despite producing goods of comparable quality and variety.

Hence then there is a case for revisiting national development or investment banks for supply of long-term, low-cost credit for industrial capital formation. Such a case has acquired greater urgency in the context of the continuation of the global financial crisis, and the need for public investment to pull the depressed economies out of the present crisis.

Another setback after the industrial reforms has been the decline in domestic industrial R&D. The licences to import technology and capital in the pre-reform era were conditional upon setting up domestic R&D centres to promote indigenous know how. After the reforms, firms no longer needed to make such efforts, and foreign firms had no reason to invest in R&D in India that could potentially compete with their parent firms' global interests. The net result: stagnation in R&D efforts, best illustrated again with a Chinese comparison.

In 1996, both China and India spent the same share of their GDP on R&D, at 0.6%. However, by 2011, the ratio for China had tripled to 1.8% of GDP, whereas for India the ratio had marginally moved up to 0.8%. Interestingly, despite its liberal FDI policy, China did not take its eyes off the strategic significance of R&D, whereas India perhaps lost its focus in the free market.

Moreover India signed a large number of bilateral free trade and investment agreements, whose outcome for industry appears to be questionable. In particular, the treaty with Thailand, a large base of the Japanese automotive industry, seems to have hurt Indian automotive firms', enabling the duty-free entry of goods. Hence it makes sense to review such agreements.

This is not to argue for unconditional protectionism for domestic industry but to seek for a more reasoned, rule-based support for industry. This should not be seen as an excuse for going back to pre-reform era. What is needed, perhaps, is the redefining and re-configuring of the boundaries of state and market in view of the changed ground realities, cross country experiences, and the valid arguments for state intervention.

Conclusions

Liberal economic reforms or the market-friendly policy framework constructed over the last quarter century has not served the manufacturing sector well, despite faster economic growth, and output diversification. The goal of rapid industrialising to catch up with Asian peers, in an open trade and capital regime employing abundant labour for labour-intensive exports, did not materialise.

The easy starting point of it would be to try producing domestically what is being imported. The sharp rise in imports during the recent years clearly shows the potential to indigenise production quickly.

With global economic recession continuing after eight years of the financial crisis, and its political fallout in terms of Brexit, or ultra-nationalism in the US, and the proposed scrapping of the Trans-Pacific Partnership by the US seem clear signals of the current limits to globalism. Considering the current global political and economic uncertainties, it would be prudent to pause and reflect on the liberal model.

There is perhaps a need to revitalise the idea of the development state for retaking the initiatives for industrialisation. Such a vision should not be misconstrued as a plea for a reversal to uncritical infant industry protection or complete delinking from international trade and capital flows. Surely, with rising agriculture productivity and structural transformation, industrial growth will have to turn increasingly to exports for sustaining domestic growth.

Yet, for a large economy like India—to paraphrase Arthur Lewis—exports will have to be the efficient lubricant for the large domestic economy, especially to meet energy import needs. It calls for strategic integration with the global economy and reinventing industrial policy keeping in view the long-term national goals.

The structuralist economic view of India's long-term constraints, as low agriculture productivity (compared to the global average), poor public infrastructure and extreme energy import dependence, seem to hold considerable value to this date. So, at a macroeconomic level, such a view would call for state intervention to step up domestic savings and public investment, and insulate the domestic economy from short term volatility emanating from the global economy.

We probably need to identify industries and products in which imports are succeeding on account of easy credit, and those which require productivity improvement. There is apparently a need for reconfiguring a strategy for capital goods development (in items like information and communications technology hardware or in solar energy), in which India has become seriously import- dependent, undermining the strategic national interests. This is not, however, a plea for blanket import substitution, and export pessimism, but for infusing technological dynamism to recapture the domestic market and the dynamic comparative advantage in trade.

Capital and technology import should be accompanied with commitments for R&D investment. There is a need to reimagine the role of domestic financial institutions to provide long-term credit for capital intensive industries, infrastructure and exports. These measures necessarily have fiscal counterparts, which need to be addressed by revisiting fiscal rules.

Similarly, domestic R&D, expenditure which has barely increased during the reforms as a share of the GDP—compared to China, which tripled the ratio—needs to be seriously viewed and corrected if our present political dispensation is serious of realising its dream of techno-nationalism.