First Shri PPP Babu Memorial Lecture  
The Challenges of Managing a More Open Economy  
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I consider it an honour to be invited to deliver the first Shri PPP Babu Memorial Lecture, instituted by the Indian Economic Service Association in memory of the late Shri PPP Babu. I got to know Shri Babu personally during my stint in the Commerce Ministry. He was a dedicated officer with a deep commitment to his profession. As many of you know, he was selected for the IAS but chose to remain in the IES because he wanted to remain a professional economist. By instituting this lecture in his memory, his colleagues in the Indian Economic Service Association have paid him a fitting tribute, which will keep his memory alive for years to come.

2. In 1991, when we were both in the Commerce Ministry, Shri Babu was one of the officers involved in planning the trade policy changes which began the process of opening up the Indian economy. He would have taken justifiable pride in seeing how much of what he was then involved in has come to pass and how successful it has been in many ways. And yet the transition to a more open economy has only just begun. Some of the earlier fears about opening up have subsided, but many difficult steps remain, and some of them are bound to be controversial. I feel it is appropriate therefore to devote this lecture to examining the problems and challenges we are likely to face in managing a more open economy.

3. The move to an open economy typically involves initiatives in four distinct areas. These are (i) opening up on the trade account, (ii) opening up the flow of foreign technology, (iii) opening up to direct foreign investment and (iv) opening up to external capital markets. Economic reforms all over the world have been characterised by opening up in all these areas and our policies have also moved in the same direction in the past five years. How have we fared in this process? Are we broadly on the right track? Do we need to move further forward? What are the challenges that lie ahead of us? These are some of the questions I propose to address in this lecture.

Opening up to Foreign Trade

4. It is well known that a number of significant steps have been taken to open up on the trade front since 1991. The changes were made in a sequence of steps over these five years and the cumulative change that has taken place can be summarised as follows:

i) Our tariff levels were among the highest in the world, with tariffs exceeding 200% on many items, and the average collection rate in 1990-91 was around 40%. In 1995-96, the peak tariff rate was 50%, and many rates were actually much lower. The average collection rate was around 20%.

ii) Imports of capital goods and raw materials and components were subjected to extensive quantitative controls in the form of import licensing. These items, with very few exceptions, are now freely importable, subject only to tariffs.

iii) Consumer goods were earlier completely banned. They remain generally restricted, but a gradual process of liberalisation has started in this area also. A few consumer goods are now allowed to be imported under OGL, and a longer positive list of consumer goods is importable against Special Import Licenses which are given to exporters (as a percentage of exports) as an export incentive. These SILs are tradeable and the market premium on SILs is currently about 8 to 10%. This means that items importable against SILs are in effect freely importable but with an effective tariff rate 8 to 10 percentage points higher than the customs duty rate.

iv) Parallel with the dismantling of quantitative restrictions and the reduction in tariffs, there has been a very important change in the system of exchange rate management. The earlier regime was characterised by an over-valued official exchange rate which was combined with extensive licensing and high tariffs to
protect domestic industry. This system helped import substituting production but it had an obvious bias against exports, since exporters of goods and services faced a highly appreciated exchange rate. The new policy combines a reduction in levels of protection with a more realistic exchange rate, which of course gives exporters a much better deal.

5. The theoretical arguments in favour of trade liberalisation are too well known, especially to an audience of professional economists, and I will not go into them in this lecture. I propose to focus instead on the empirical issue of how we have fared under trade liberalisation, especially in the context of the fears that were aired at the time the process began. These fears related to the adverse impact of trade liberalisation on domestic industry and the adverse impact on the balance of payments.

6. Most observers would agree today that the early fears that Indian industry would not be able to cope with the process of trade liberalisation have proved to be completely unfounded. Far from a collapse of Indian industry there has in fact been a robust growth in both investment and production. Industrial production had collapsed in the year of crisis to virtually zero growth in 1991-92 and only 2.3% growth in 1992-93. It recovered quickly to 6% in 1993-94, 8.6% in 1994-95 and around 11% in the first seven months of 1995-96. Trade liberalisation does not seem to have hurt Indian industry. In fact, if we listen to what Indian industry itself has to say, they are much less worried about competition from imports than about scarcity of domestic and foreign resources for investment, and poor quality of infrastructure.

7. The sector where import liberalisation has proceeded most rapidly is the capital goods sector. Motivated by the desire to accelerate the modernisation of Indian industry, imports of capital goods were put on OGL early in the reform process and tariffs on capital goods were also sharply reduced. It is instructive to consider the performance of the capital goods sector in this period. This sector was **badly hit by the crisis, with a decline of 12.8% in 1991-92, and there was a further marginal decline in each of the next two years. However this slack performance was largely a reflection of the fact that investment activity was low in the initial years after the crisis. Once investment levels recovered in 1994-95, the capital goods sector has shown great buoyancy. Capital goods production recovered strongly in 1994-95 with a growth of 25% which has been followed by 18% growth in the first seven months of 1995-96.**

8. Why have the fears of collapse of Indian industry not materialised? The reason is that trade liberalisation is not merely a process which exposes Indian industry to the onslaught of vicious external competition. It does expose industry to competition and this is an important positive factor, but it also helps Indian industry to meet competition in two ways. First it provides industry with opportunities to strengthen its competitive capability by providing access to better capital goods, and to raw materials and other inputs at prices more closely aligned to world prices. This encourages technological modernisation and upgradation, and improves cost competitiveness. Second, trade liberalisation is not just a process of lowering the protective barriers which keep out imports. It is, as I have explained, essentially a shift from a regime of protection combined with an unrealistic exchange rate, to a regime with low protective barriers and a more realistic exchange rate. The shift to a realistic exchange rate offsets the lowering of tariffs and helps domestic industry to compete effectively against imports even at lower tariff levels.

9. Interestingly, small scale producers stand to benefit the most from a process in which capital goods and basic raw materials such as steel, aluminium and plastics become freely available at costs close to world prices. It is no accident that the industrial production data show that the small scale sector has consistently grown faster than overall industrial production in each of the last four years.

10. Let me now turn to the second fear about trade liberalisation that it will have an adverse impact upon the balance of payments. This fear is usually based on the perception that liberalisation will lead to a flood of imports and a corresponding unsustainable increase in the current account deficit. The fear of a flood of imports is essentially based on the
assumption that domestic industry will not be able to compete and as I have already explained, this fear is greatly exaggerated. The degree of import expansion under trade liberalisation is much less than most people think if only because trade liberalisation implies an exchange rate adjustment. Second, and more importantly, the shift to a more realistic exchange rate greatly improves the incentive for exporters and therefore improves export performance. Both forces can be seen to be working in India if we look at the trade data of the past five years.

11. On the import side, despite massive trade liberalisation import growth has been well within reasonable limits. The ratio of imports to GDP was ______ % in 1990-91 and it has increased to only ______ % in 1995-96. Is this import ratio excessive? Should we be trying to compress imports at this stage? In answering this question we would do well to compare India's import to GDP ratio with the ratio prevailing in other countries. India's ratio of 9% compares with 19% in China, 29% in Korea, 27% in Indonesia, 43% in Thailand and a whopping 80% in Malaysia. I am not suggesting that we should target our import ratios to such high levels. These levels can only be sustained if our exports can sustain them. But, the comparison is relevant only to establish that we should not be frightened by an import ratio of 9%! In fact, we should expect a gradual increase in this ratio over time and focus our energies on how to generate the exports needed to pay for the rising imports.

12. Turning to exports, there is little doubt that India's exports have responded well to trade liberalisation. In the three years from 1992-93 to 1995-96, exports have grown at an average annual rate exceeding 20% in dollar terms, much faster than the growth of world trade, and faster than in any three year period in the past 20 years. Our share in world trade, which had declined steadily through earlier years, has actually increased in this period. Trade liberalisation and the realistic exchange rate have created a situation in which the major constraint on our export potential today is not our cost competitiveness but our infrastructure constraints, which of course we must now address as a matter of priority.

13. The net effect of trade liberalisation on the balance of payments is perhaps best measured by the ratio of exports to imports. This ratio has increased from a little over 60% in the second half of the 1980s to around 90% in the past three years. The current account deficit, which averaged around 2% of GDP in the second half of the 1980s, and reached a peak of 3.2% in 1990-91, is down to around 1.6% in 1995-96. With a reasonable inflow of foreign investment, and I will have more to say on this subject on a little while, a current account deficit of this size can be easily financed, while keeping our external debt within reasonable limit.

14. Should we proceed further with trade liberalisation? The record of performance of the past few years certainly suggests that we should confidently proceed further down this road in the years ahead. Further movement is certainly needed. We have made impressive changes, but our trade regime remains more restrictive than those prevailing in the fast growing developing countries of East Asia and Latin America. There are three basic problems we must address.

   i] Our tariff structure contains many anomalies with tariffs on inputs being higher than tariffs on outputs.

   ii] Apart from anomalies the average level of tariffs is too high.

   iii] The present trade policy remains highly restrictive on the import of consumer goods. Their problems need to be addressed in the years ahead if we want to achieve the transition to a more open economy.

**i] Tariff Anomalies**

15. The first priority must clearly be given to removing tariff anomalies. These anomalies have arisen because we are making a transition from a system which was characterised by very high and varying levels of import duty on different items combined with import licensing as a protective device. In this system, high duties on inputs, leading to a tariff anomaly, did not really matter if the end product was protected by import licensing restrictions. This was the case for example in the capital goods sector where tariffs on inputs such as steel were
often much higher than the tariffs in machinery but machinery produced in India was not allowed to be imported through licensing. With the removal of import licensing, however, tariff anomalies begin to bite. The easiest way to eliminate tariff anomalies is to make duty rates uniform across all items, but this may be too much a shock to producers who need more time to adjust. The pace at which tariffs are being reduced has therefore been gradual, but this has meant that tariffs on certain inputs, especially metals and plastics, are sometimes higher than the tariffs on outputs, especially capital goods. Many anomalies have been removed in the past two years, but some still remain. We must try to remove these anomalies as quickly as possible. Too much should not be made however of the mere existence of an anomaly. Simply because an anomaly exists does not mean, as is sometimes claimed, that domestic industry is being subjected to negative protection. If tariff rates are the same for inputs as for outputs, the effective rate of protection of value added is the same as the common tariff. When the tariff on inputs is higher than the tariff on outputs then the effective rate of protection on value added is lower than the nominal rate, but it is not necessarily negative. Whether a tariff anomaly actually leads to negative effective protection depends upon the extent of the differential and the relative importance of the input in production. In identifying anomalies to be eliminated we should focus on anomalies which lead to negative effective protection or very low levels of effective protection. Anomalies which lower effective protection from high levels to moderate levels are not a priority.

ii] Reducing the average level of tariff

16. Looking beyond the elimination of tariff anomalies, we must also aim to reduce the average level of our tariffs which are still too high compared to those prevailing in our East Asian neighbours. Our average tariff collection rate of 20% compares with 4% for Malaysia, 5% for Indonesia, 9% for Thailand and 6% for China. We may not be able to bring our tariffs down to such low levels in the future, but we must surely move quickly to close the gap. If we want to compete with these countries, and indeed also integrate more closely with them as is evident from our desire to join APEC, we must move to tariff convergence within a reasonable period of three to four years.

17. The feasibility of achieving this transition over this time span has to be judged by two considerations. One is the pace at which Indian industry can adjust to further reductions in protection. The other is the pace at which the Government can afford to forego customs revenue, which will obviously depend upon the buoyancy generated in other revenue sources because of the ongoing tax reforms. On both considerations, a time span of three to four years is eminently feasible.

iii] Trade Policy for Consumer Goods

18. Let me now rum to the trade policy for consumer goods, which is perhaps more controversial than most other areas of trade policy. There is today a wide consensus on the benefits of a more liberal move towards a trade policy for capital goods, raw materials and other inputs into production, all of which are seen as improving the competitive strength of Indian industry. But there is a curious hesitation to extend the logic of trade liberalisation to consumer goods. This is either because consumer goods are somehow regarded as "inessential", or because some of them are viewed as "luxury goods" which should not be liberalised.

19. The flaw in this approach becomes evident if we simply consider the consequences of liberalising other sectors of the economy and not liberalising consumer goods. If tariffs on capital goods and raw materials are to be brought down to East Asian levels to make these industries internationally competitive, but consumer goods industries remain highly protected, we will create an economy in which one part of industry will benefit from very high levels of protection while the rest will be forced to compete with the rest of the world. In this situation, the relative profitability of investment in consumer goods will increase compared to other sectors, and this will seriously distort investment signals. Investors will shy away from investing in the more competitive areas, and will only go into consumer goods. Paradoxically, we will have pushed investment away from the upstream sectors of capital goods and basic intermediates which are usually regarded as "essential" or "core" sectors.
and into the so called "inessential" sector. What is worse, such a policy will perpetuate what is called "screw driver" industrialisation in the consumer goods sector, since low tariffs on inputs will encourage producers in the consumer goods sector to perpetuate high dependence upon imported components.

20. A rational approach to trade policy for the consumer goods sector needs to move away from emotive concepts of "inessentiality" and address the issue on the basis of economic reasoning. Capital goods, raw materials and basic intermediates are undoubtedly important, but they are of use only if they ultimately produce consumer goods, either durable or non-durable. Except for houses, which are not classified as consumer durables in the national accounts, the only goods which affect welfare are consumer goods. It is therefore odd to follow a policy which advocates liberalisation for capital goods and raw materials on the grounds that it makes these sectors more competitive but to stop short at consumer goods which is the point where consumers can actually benefit from efficiency.

21. If Indian industry can compete in other areas there is no reason why it cannot compete in consumer goods also. And from the consumer point of view there is every reason why such competition should be encouraged so that the consumer can get the benefit of high quality and low cost.

22. We must also remember that trade liberalisation in consumer goods will help improve our export capacity. For quite some time, our competitive advantage as exporters is more likely to be in consumer goods than in other areas. If our industry cannot compete against imports with moderate tariffs in the home market, it will be totally unable to stand up in the ruthlessly competitive world markets. Opening up the consumer goods sector will push the domestic consumer goods industry to upgrade its products in terms of cost and quality and thus strengthen its export capability.

23. The argument that consumer goods are luxury goods and therefore should not be allowed to be imported is also deeply flawed. The concept of luxury goods is certainly relevant in our situation and there can be little doubt that goods defined as luxury goods should pay high rates of taxation. Some luxury goods, which represent "socially undesirable" consumption, (however this is defined) can even be banned or prohibitively taxed. But discouragement should apply equally whether the luxury good is domestically produced or imported. In other words, we should have very high rates of excise duty on these items which would be charged on both domestic production and also, in the form of an equivalent countervailing duty (cvd), on imports. It is not logical to impose high tariffs (or an absolute ban which is equivalent to a prohibitive tariff) on luxury consumer goods, and then allow inefficient domestic production of the same items behind the high level of protection. This only imposes high costs on domestic consumers without allowing the exchequer to cash in on the scarcity rent which is appropriated by domestic producers either in the form of abnormal profits, or inefficiency or both.

24. It can be argued that since the domestic consumer goods industry has been from international competition for a long time, it may need a more extended period of protection so that tariff rates on consumer goods would have to be higher than on the other sector. There is merit in this argument but it is easy to calibrate tariff levels to ensure that there is no flood of imports. Indeed, the mechanism of allowing consumer goods imports against Special Import Licences ensures that a flood cannot occur, since the total volume of SILs is limited.

25. The stated policy of the government is to liberalise the consumer goods sector by gradually shifting items which at present cannot be imported to the positive list of items which can be imported against SILs. It can be argued that the system is in fact ready for a bolder step of shifting to a negative list system in which all consumer goods would be importable subject only to a negative list. Since the additional demand for consumer goods imports would meet with a fixed supply of SILs (determined by the total level of exports) any excess demand for consumer goods imports would be reflected in a rise in the SIL premium which would accrue to exporters. Depending upon the level of the SIL premium the volume of SILs could either be expanded or the level of import tariffs on consumer goods raised. In
case there are individual consumer items which flood the market for those items, corrective steps can be taken by shifting these items to the negative list or simply raising the tariff on these items to give domestic producers more time to adjust. Liberalisation of consumer goods through the SIL route therefore ensures reasonable control over the total volume of consumer goods that are likely to be imported and also ensures that it is exporters who benefit from any unexpected excess demand. By opening up the sector it would ensure massive upgradation of quality within a very short time.

26. The higher tariffs on consumer goods would also provide additional buoyancy to revenues which would help in maintaining overall fiscal balance, which as we shall see is a very important pre-requisite for successful management of an open economy.

Opening up to Technology

27. Let me now turn to the second aspect of openness, which relates to freedom of access to foreign technology. By technology, I mean disembodied technical knowhow, which is not necessarily connected with foreign investment, and which is paid for either by lumpsum payments or royalties. In a relatively closed economy there is little competitive pressure on domestic producers either to introduce new products or to use new processes which reduce costs. The demand for foreign technology in such a situation is therefore limited. As the economy is opened up to trade flows, the competitive pressure on domestic firms increases and this generates demand for new technology in order to upgrade product quality and also to reduce costs. Not only does trade liberalisation create a demand for new technology, it also makes absorption of new technology feasible in practice. This is because new technology often requires access to new capital goods and access to raw materials or other inputs. If the trade policy denies access to these items, or even makes them unduly expensive because of high tariffs, it nullifies the effect of freer access to pure knowhow. It is only when easy access to technology is accompanied by access to capital goods and raw materials at prices close to world prices, that new technology can be evaluated on the basis of underlying economics, and the absorption of new technology becomes a practical reality.

28. A process of opening up on the trade front must therefore be accompanied by complete liberalisation of access to knowhow. If domestic producers are to face competition from foreign producers in product markets, they must be able to access the best technology to have the best chance of showing their competitiveness. This is not to say that domestic technology development should be ignored. It is necessary to provide support to domestic technology development through appropriate allocation of public resources, within our overall resource constraints, and also through suitable fiscal incentives for research and development which would encourage domestic industry to invest in technology development. Significant steps have been taken recently to improve the incentives for domestic industry to engage in research. But indigenous technological development should not be at the expense of the user industry. The choice whether a particular technology is good enough in a competitive environment must ultimately be left to the user.

29. The present policy for access to foreign technology consists of a two stage process. Technology agreements involving a lumpsum payment of Rs. 1 crore with royalty percentages within the norms of 5% for domestic sales and 8% for exports are cleared under a fast track procedure. Agreements involving higher levels of lumpsum payments, or larger royalties, require individual approval of Government. Representations have been made by industry that these limits were fixed quite some time ago and need to be liberalised. There is a strong case for such liberalisation in present circumstances. When trade was not liberalised, and domestic producers benefited from highly protected domestic markets, it was felt that free access to foreign technology may a lead to wasteful import of unnecessary technology. It was also felt that foreign suppliers would be able to extract very high royalties from domestic producers, with a consequent large foreign exchange outflow. Once trade is liberalised and tariffs have been lowered, so that goods are allowed to flow freely, there is little justification in continuing with a restrictive regime for technology. On the contrary, technology imports should be freed substantially so that Indian producers have easy access to whatever technologies are available in the World.
Opening Up to Foreign Direct Investment

30. The third area of opening up relates to foreign direct investment. All over the world developing countries, including even communist countries such as China and Vietnam, have adopted aggressive policies to attract foreign direct investment in a wide range of sectors.

31. There are basically three reasons why countries seek to encourage FDI:

i] First, it provides a significant addition to the total volume of investible resources in the country. Not all countries can succeed in attracting foreign direct investment but those that do have benefited substantially. In the East Asian region for example, in 1995 the net inflow of foreign direct investment was $38 billion into China, $4.5 billion into Indonesia, $2.3 billion into Thailand and $5.8 billion into Malaysia. The Chinese figures may be overstated because they are said to include domestic capital which first flows out into Hong Kong and then "round trips" back as FDI and this amount has been estimated by the IMF to be as much as $10 billion. However, even if we adjust for this the inflow into China is around $28 billion. On the basis of these figures India should easily be able to attract around $6 billion per year. This would provide approximately Rs.20,000 crores in the form of equity. In addition, the presence of significant volumes of foreign direct investment inevitably enhances international credit rating assessments which in turn helps to mobilise external commercial loans.

ii] Apart from the additional resources which it makes available, foreign direct investment brings in technology and new management practices. A great deal of modern technology is commercially available, and as I have argued earlier, we should access to such technology should be liberalised to strengthen the competitive capacity of domestic industry. However not all technology is commercially available and a great deal has to do with everyday management of production, where technology gaps are not easily identified. Actual presence of MNCs therefore helps in the induction and diffusion of new technology over a wide front.

iii] Finally, foreign direct investment is often seen as a vehicle which can bring us benefits from the process of globalisation, in which MNCs locate production units globally and use these units, and the associated domestic suppliers to these units, as potential sources of intra-firm trade. It is well known that the proportion of world trade accounted for by intra-firm trade has grown substantially in recent years and now accounts for about 30% of total trade. Extensive MNC presence provides an opportunity to participate more effectively in this type of trade.

32. All these considerations were felt to be relevant in our situation when we decided to open up to foreign investment in 1991. It is time to review how we have fared in these past five years. The actual inflow of foreign direct investments has increased from less than $100 million in 1990-91 to almost $2.0 billion in 1995-96. This may be less than our full potential, considering the large flows being attracted by our East Asian neighbours, but it is certainly better than many had forecast when the process began. The fact is that foreign investors take time to respond to policy changes, and they also look not just at foreign investment policies but at the total policy environment. Although our foreign investment policies were announced in 1991, it is not until 1993 that trade liberalisation was seen to have gained momentum. The announcement of current account convertibility, an important signal for investors, only came in 1994. The time lag in investor response can be seen in the build up of foreign investment approvals over the past five years. Total approvals were $1.8 billion in 1992, $3.6 billion in 1993, $4.3 billion in 1994 and approximately $6 billion in 1995. These figures suggest that actual inflows of foreign investment could easily increase from around $2 billion in 1995-96 to $6 billion per year in three years time. This projection obviously assumes continuity of the basic policy of attracting foreign investment, continued progress in trade liberalisation, and most important of all, an improvement in infrastructure. If a significant part of the foreign investment is directed at infrastructure to begin with, as is the
intention of the current policy, it will obviously help to create the conditions which will stimulate larger foreign inflows in future.

33. Does a large inflow of foreign investment also pose problems? Is Indian industry comfortable with the entry of foreign investors? These questions have figured in the Press from time to time but it is difficult to generalise from particular experiences. It is entirely possible that as Indian industry collaborates with foreign partners there will be problems and frictions in some cases. Such problems are not unique to international joint ventures. They arise even when there are domestic partners indeed even within families. The solution obviously has in much more careful planning on both sides before they enter into partnerships. In an open competitive economy, the terms of joint ventures should essentially be left to the partners concerned.

**Opening up to External Capital Markets**

34. Let me now turn to the fourth aspect of opening up which relates to access to external capital markets. This takes two forms: external commercial borrowing and foreign portfolio investment and both flows provide domestic investors with access to external finance without necessarily involving a partnership with a direct foreign investor. One of the remarkable features of the international capital markets has been the enormous growth in the size of these flows over the past ten to fifteen years. Official flows comprising of multilateral flows have declined in relative importance while private flow increased substantially. If we want to finance a current account deficit of around 1.5 to 2 per cent of GDP in the years ahead, and this level of deficit is probably unavoidable if we want investment levels of 26 per cent or so, we need to rely upon these flows to a significant extent.

35. There are important differences between commercial borrowing and portfolio flows and these are relevant in determining the balance to be struck between them.

i] External commercial borrowing is part of external debt and imposes a definite servicing burden including both interest and principal repayment irrespective of the profitability of investment. These debt service payments form part of the country's debt service profile which is closely monitored by international financial institutions. By contrast, portfolio capital involves regular outflows only on account of dividend payments which depend upon profitability and have no fixed principal repayment schedule. These outflows also do not figure in currently used measures of creditworthiness. In this respect portfolio flows are like direct foreign investment. However, unlike direct foreign investment, portfolio flows are volatile in the sense that they can flow out at any time. In practice, this means the net inflow can quickly become zero, and in extreme cases the flow can even become negative. This potential volatility of portfolio capital introduces an element of vulnerability in the external account.

ii] External commercial borrowing typically involves loans denominated in foreign currency so that the borrower takes the exchange risk. Portfolio capital typically involves rupee valued securities when the exchange risk is taken by the investor. This is one of the reasons why portfolio capital is potentially volatile since anticipation of exchange rate changes may affect the flow of portfolio capital temporarily.

iii] Finally, portfolio capital flows into the capital market may be used to acquire shares in the secondary or the primary market. They are not specifically directed to finance new investment. External commercial borrowing on the other hand can be directly linked to new investment and can also be directed to particular sectors.