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Indian reforms in the manufacturing and financial sectors: Winners and losers

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The reforms introduced after the liquidity crisis in 1991 helped to further open up the Indian economy, a process already begun under Rajiv Gandhi's government. The reforms were intended to introduce greater competition, particularly in manufacturing industry, both with foreign producers and between local firms. They were introduced gradually: steps to open up the economy had already been taken in the 1980s, and caps on FDI were lifted in the aftermath of the liquidity crisis.

Greater competition pushed Indian firms to produce more, to export more, and hence to invest more. Investment initially stimulated growth but ultimately generated overcapacity; the weakest firms went to the wall and concentration took place among those that were left.

This paper has a twofold purpose: first, to analyse how Indian manufacturers reorganized once the reforms were fully implemented; second, to illustrate the key role played by the banking system once it had adjusted to its new functions. It concludes with an assessment of the macroeconomic consequences of reforms for the Indian economy.

I. Far-reaching changes in the manufacturing sector

A distinction may be made within India's manufacturing sector between large industries and small-scale industries (SSI). The Industries Development and Regulations Act of 1951 defines the latter as firms with capital of less than 10 million rupees, employing up to 10 employees, or 20 in the case small firms without access to electrical power. This breakdown roughly corresponds to the distinction between the formal and the informal sector (almost 90% of SSI units belong to the informal sector). Before the reforms, small industries were protected in a number of ways, the most relevant one being reservation. This meant that a long list of goods, mostly consumer goods, were produced exclusively by small-scale industries under a special set of measures – mainly concerning labour management – particularly favourable to entrepreneurs. By contrast, large firms had to apply labour laws much more beneficial to employees and were not allowed to operate in reserved sectors.

Manufacturing reforms were introduced step by step. In the early years, up to the mid-1990s, small enterprises continued to enjoy protection, especially from foreign competitors, as import tariffs on consumer goods were extremely high. But competition among Indian producers began as soon as de-reservation began. Bigger firms then crowded out smaller ones.

Reforms triggered a new wave of investment resulting in quick growth

In the first half of the 1990s, only the formal sector was affected by reforms. The easing of import restrictions gave enterprises in the formal sector access to less expensive raw materials and intermediate goods and more efficient equipment. At the same time, foreign firms entering the Indian market proved much more interested in domestic opportunities than in turning India into an export platform. As the domestic market was far from saturated at the time[1] production expanded, triggering a huge wave of investment by Indian firms which wanted to keep their market share against foreign investors.

Manufacturing industry, formal sector

(Annual compound growth rate, %)

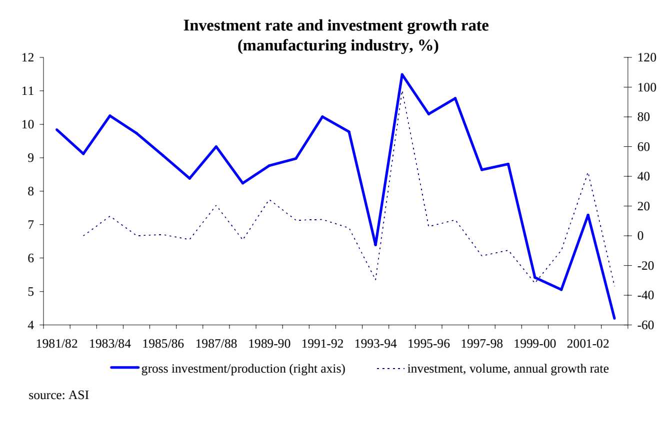
	1981/82-2002/03	1981/82-1990/91	1992/93-2002/03	1992/93-1996/97	1997/98-2002/03
Production	6.2	9.2	4.7	8.5	1.1
Employment	0.04	0.36	-0.8	2.0	-11.1
Labour productivity	6.1	8.7	5.5	6.3	3.6
Wages per head	0.7	3.4	-1.3	0.4	-2.4
Investment (growth rate)	1.9	7.0	2.3	11.1	-10.2**
Profit rate*	14.3	13.2	15.6	16.6	15.3

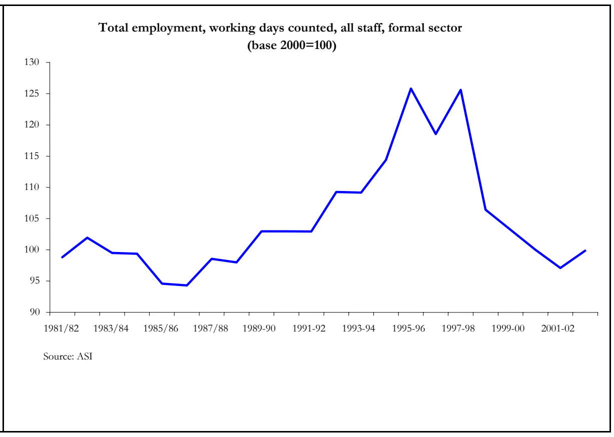
Source: ASI, CSO. (*) Level. Interest included. (**) Covers the period 1996 -2002

Between 1992/93 and 1996/97, the formal sector grew by 8.5% at an annual compound rate (table). Employment improved (Chart 2), but labour productivity grew even faster. Competitiveness increased sharply, but wages did not rise at the same pace despite high productivity growth. Investment rose at an annual compound rate of 11% (Chart 1).

[1] It took two years to buy a scooter, for example.

Charts 1 & 2



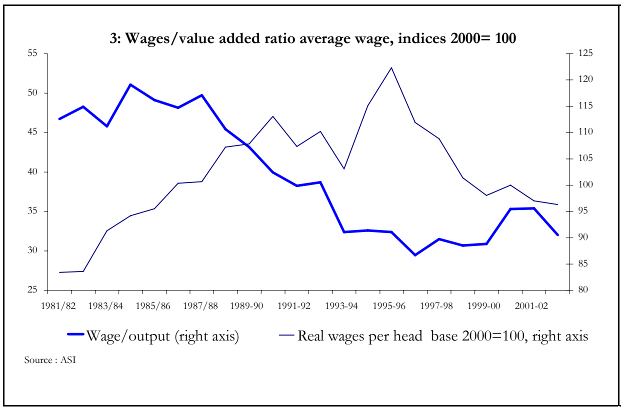


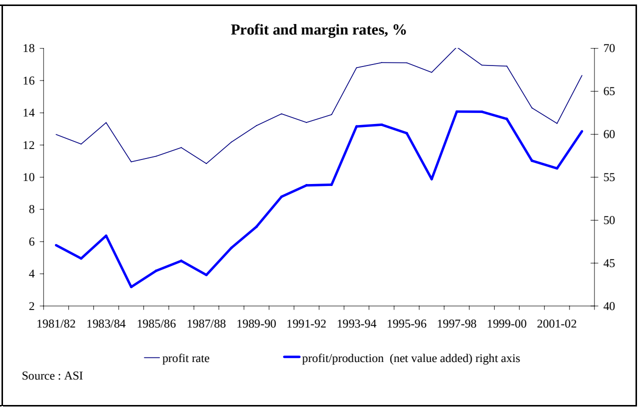
Investment was financed from three main sources: self-raising funds from higher profit margins, bank loans (banks were able to lend much more to firms after the reforms), and the financial markets, which were boosted by allowing foreign portfolio funds to enter local markets.

In the second half of the decade, over-supply resulted in a sharp slowdown

The business cycle reached a turning point in 1995/96. Between then and 2001/02, production growth in the formal sector slowed to a yearly compound rate of 1.1%. Over-investment in the previous period resulted in idle capacity in industries such as consumer durables and capital goods. As a result, investment fell at an annual compound rate of 10%. Despite a significant decline in output, productivity still increased by 1% a year, albeit compared to 8.5% in the previous period. Continued productivity growth was made possible by a sharp drop in employment (Chart 2), which fell at a yearly compound rate of 11%. The formal manufacturing sector lost four million jobs in six years, representing about 23% of existing jobs in 1995/96, while the informal sector lost jobs at an annual compound rate of 1%, against 1.7% in the first half of the decade. This adjustment was possible in spite of existing labour laws, heavily criticized by entrepreneurs as the main hurdle to improvement in the Indian economy.

Charts 3 & 4





Adjustment in employment was therefore critical to the success of reforms in the formal sector. It resulted in the halving of wages as a share of GDP (Chart 3). Profits also decreased slightly (Chart 4).

Small-scale industry badly battered

The government had looked after small-scale industries (SSI) since independence but de-reservation, which affected most of the sectors in which SSI operated, resulted in competition with large enterprises. As a result, SSI grew more slowly than larger industries; their share of national revenue amounted to 8% of the total in 2001, compared to 11% ten years earlier.

Many of them went bankrupt and closed down, hamstrung among other things by lack of access to credit, infrastructure (eg, electricity), communications and technology.

Nonetheless, the SSIs maintained their share of total exports at around 30%, while their share of employment rose: they currently account for 66% of total employment (formal and informal sectors), compared to 48% in 1990/91.

The informal sector has been at a particular disadvantage. In the first half of the 1990s it experienced a recession; value added shrank at an annual compound rate of 1%. 10% of firms closed and employment fell by more than 1% a year. Investment, which stood at 50% of the total in the early 1990s, is only 20% nowadays (Nagaraj, 2003). Although the reforms were supposed to be especially beneficial to SSIs, as they were gearing the economy to become a champion exporter of low value-added goods, they clearly failed on that count.

Foreign firms introduce more competition, then concentration

India's domestic market used to be relatively closed to foreign investment. The Foreign Exchange Regulation Act (FERA) of 1973 imposed severe restrictions on foreign investment: previous authorization was mandatory and foreigners were not allowed to own more than 40% of an Indian firm. Furthermore, under the Monopolies and Restrictive Trade Practices Act (MRTP) of 1969 the government could oppose a foreign firm's acquisition of an Indian company if it considered that such a move would lead to a concentration of capital detrimental to the general interest.

Policy on foreign investment changed radically in 1992. The government created the Securities and Exchange Board of India (SEBI), which supervises India's capital markets, and introduced the New Industrial Policy (NIP), intended to encourage foreign investment. Since 1994, SEBI has implemented guidelines on IPOs. Bigger firms started arriving in 1997, triggering concentration through mergers and acquisitions. Three-quarters of such transactions involved manufacturing industry, especially in the machinery and non-electrical equipment segments. Food and beverages accounted for 13%, marked by vertical integration (Coca Cola and MacDonald being the main examples). As a result, by the end of the 1990s foreign firms accounted for 30% of the domestic market in manufacturing industries.

Mergers and acquisitions also occurred in the services sector, accounting for 30% of total services in 1999, mostly in telecommunications and electricity. Foreign direct investment allowed multinationals to increase their share of the Indian market, where oligopolies now prevail.

Despite the reforms, the weaknesses of Indian firms became even more apparent and in some cases actually increased (Topalova, 2004).

- The banking credit/investment ratio, which exceeds 50% of total investment, is too high. Though it has fallen over the last 15 years – it was almost 70% in 1998/99 –, it is still high compared to western levels.
- The debt structure has become more vulnerable; the debt/assets ratio reached 140% at the end of the 1990s, compared to 120% at the beginning of the decade. Furthermore, short-term debt amounts to 30% of total debt, compared to 10% in the early 1990s.
- 22% of firms cannot cover their interest charges, compared to 8% ten years earlier.
- Governance fails to comply with legal rules, thus increasing agency costs. 50% of firms are owner-managed. Good governance rules exist, but they are not enforced.

Greater openness has resulted in a new division of labour between foreign and Indian companies

Competition with foreign firms had three main consequences for Indian firms. First, the Indian market, under-supplied before the reforms, became saturated, causing profit margins to fall. Second, Indian firms in the formal sector which already had some experience with exports, turned to the world market in search of higher profits (Poddar, 2004). Third, foreign firms, not interested in turning India into an export platform, took a larger share of the domestic market. This resulted in a new division of labour, with Indian firms occupying the lower end of each sector.

Three main cases illustrate the changes experienced by Indian firms:

- In the automobile sector, foreign firms led the market for luxury cars while Indian firms dominated the market for trucks and taxis.
- In the machine-tool sector, Indian producers suffered heavy losses as their conventional goods were unable to compete with more sophisticated products with built-in electronics. In the end Indian firms exported their conventional machines to developing countries, while foreign firms supplied the Indian market with more sophisticated goods.
- In textiles and clothing, the opening-up of markets and de-reservation had severe consequences in the informal sector, which dominated the clothing segment. In textiles, especially yarn, of which India is the world's biggest exporter, the end of the Agreement on Textiles and Clothes (ATC) favoured big exporters to the detriment of smaller ones.

II. Adjusting the financial sector to the New Economy

Since independence, India's financial system has borne the brunt of policies promoting industrialization. In this context, both public and private banks were geared to financing manufacturing firms at low cost, through subsidized credit. Agriculture also took a considerable share of public finance.

Far-reaching reform of the Indian banking system

The Indian banking system experienced successive waves of nationalization, with the result that by the beginning of the 1990s virtually the whole system was in the hands of the state. Credit was almost entirely pre-allocated to priority sectors. Banking regulations dried up banks' liquidity, through a high cash reserve ratio (CRR) (around 15%) and Statutory

Liquidity Reserves (SLR) (40%), designed to avert bank failures. 40% of the remaining available resources were allocated to priority sectors (agriculture, small scale industries). Interest rates disregarded risk (which incidentally was low). These regulations artificially lowered the cost of capital, especially for public enterprises and priority sectors. No consideration was given to banks' profitability.

Reforms dismantled these regulations: the CRR was gradually reduced until by 2005 it amounted to 5%. The SLR was set at 25%. At the same time the government introduced the Basel capital adequacy regulations. The CAR (capital/assets ratio) was initially set at 8%, but at first only a few banks were able to meet it. The government later raised it to 10%, a level that most banks were able to comply with.

The government recapitalized the banks and opened their capital to private investors, though it limited their stakes to 49%. Paradoxically, these measures allowed banks to increase the proportion of public-sector securities in their assets as interest rates on public debt rose, since these assets were highly remunerative and less risky than loans to private firms. In the meantime, loans fell from 90% to 80% of banking assets as banks focused on other activities, like stock market flotations.

After the reforms, non-banking financial institutions could no longer fulfil their mission

Before the reforms, non-banking financial institutions like development financial institutions (DFI) and rural and urban cooperatives played a big role in financing targeted sectors, such as agriculture and the rural and urban poor. The government funded these institutions by diverting banking liquidity. The reforms placed the DFI and the cooperatives under the supervision of the Reserve Bank of India (the central bank), forcing them to follow the rules that applied to regular banks. As these institutions were not intended to function like banks, they could no longer fulfil their tasks. They lacked the necessary connections that would allow them to operate as retail banks; specializing in long-term credit, their liabilities – mainly high-interest, long-term securities – were not able to fund short-term loans like those extended by retail banks.

Insurance companies were mostly publicly owned until 1999; thereafter the Insurance Regulation and Development Act authorized joint ventures with private capital. Pension funds are still forbidden but hedge funds are now permitted, putting an end to the state monopoly of the Unit Trust of India.

Since the beginning of the reforms, Indian capital market have been opened up to foreign investors. At the same time, Indian firms have been able to borrow on foreign capital markets by issuing American Depositary Receipts (ADRs), Global Depositary Receipts (GDRs), Foreign Currency Convertible Bonds (FCCBs), and External Commercial Borrowings (ECBs).

Overseas Corporate Bodies (OCBs) and non-resident Indians (NRI) are allowed to invest in Indian companies. NRI and Foreign Institutional Investors (FII) are authorized to invest in all kinds of financial goods and total convertibility of these funds is nowadays guaranteed. Indian hedge and mutual funds are allowed to set up affiliates in foreign countries in order to buy foreign securities.

III. Under the sway of international financial markets

The reforms made the Indian financial system more profitable. Since solvency and risk minimization are the main criteria for lending, the following consequences appear.

1. Concentration in manufacturing industry because of limitations on subsidized loans

- SSI found it difficult to get credit; loans by DFI diminished as a consequence of the new rules governing their activities. Loans from commercial banks to SSI fell from 14% of total credit extended by them in 1992 to 8% in 2004 (Rao et al., 2006).
- Indian companies registered higher debt/equity ratios, along with higher capital costs.
- More expensive credit and higher capital costs resulted in concentration through mergers and acquisitions, and in foreign companies increasing their market share.
- Difficulties in finding enough credit made it even more difficult for Indian companies to compete with multinationals. They were unable to submit bids when the government put state-owned firms up for privatization, with the result that most privatized companies were bought by foreigners.
- Indian companies had serious trouble finding the necessary funds to restructure; they had to rely mostly on their own funding, thus making it more difficult for them to improve their competitiveness in relation to multinationals.

2. Public expenditure constrained because monetising deficits was definitively prohibited

As it has no longer been possible to automatically monetize fiscal deficits since 1997, they have to be funded on the financial markets. This increases debt service, to the detriment of public expenditure in other areas such as public investment, infrastructure, social services, education and sanitation.

Subsidies for the poor are considered inefficient and too costly in terms of fiscal policy and there is considerable pressure to reduce them, at least as a proportion of public spending.

Financial constraints on public budgets will be even tighter from 2006, as the RBI will no longer be able to buy public bonds on the primary market. Public debt has soared, reaching 80% of GDP in 2005.

3. Expenditure on agriculture curtailed

Agricultural subsidies are seriously criticized: they are considered to be badly targeted, inefficient and too much of a drain on the public purse. Despite these criticisms, they rose at current values between 1980 and 2000, though in relative terms, they fell. Agricultural price subsidies also fell when deflated by relative prices.

Public investment in agriculture has fallen. Private investment, when it substitutes for public investment, is less efficient than the latter. (For instance, private irrigation and private power generation are less efficient than equivalent public infrastructure).

Subsidized credit to agriculture from credit cooperatives and other specialized institutions diminished on account of the weakness of their balance sheets. Considered riskier and less profitable than credit to other sectors, regular banks were reluctant to grant loans to farmers. Furthermore, the government liberalized interest rates and closed bankrupt bank affiliates.

Under these circumstances, growth in loans by commercial banks to the agricultural sector slowed from 15% in the 1980s to an annual compound rate of 11% in 1992-2000. Rural banks' lending also slowed, from 26% in the 1980s to 18% in the 1990s.

Overall, outstanding credit grew at an annual compound rate of 9% in the 1990s, compared to 20% in the 1980s. In real terms, it was less than 2% in the 1990s, against 8% in the 1980s. Outstanding credit to agriculture from state banks accounted for 17% of total outstanding credit in the 1980s but only 10% in the 1990s.

As a result, there were profound changes in the source of rural credit.

- The cooperatives' share of total credit to agriculture fell to 31% in 2003/04, compared to 49% in 1990/91. The share of scheduled commercial banks rose to 60% in 2003/04, against 48% in 1990/91, while the share of regional banks amounted to 9%, against 3% in 1990/91. These changes increased the cost of capital.
- Credit from moneylenders – at usurious interest rates – increased, reversing the trend observed since the 1950s. It had bottomed out at 16% in the early 1980s but has risen again since then; in 2002 it amounted to 27% of total lending (Rakesh Mohan, 2006).

4. Greater inequality between households

With employment becoming more precarious, inequality increased substantially. Well-off households enjoyed consumer credit, which enabled them to acquire more luxury goods such as cars, electronic goods and domestic appliances. Stronger demand led to higher levels of industrial output and investment.

At the same time, the situation of peasant farmers worsened. Their revenues were adversely affected by the low income elasticity of food consumption: demand for agricultural produce does not rise at the same rate as the income of the well-off urban classes, while there is little scope for higher demand from poorer populations since their income grows slowly or even declines.

In the long term, reforms could hold back India's growth rate. In the short term, India's economy is subject to big swings.

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