

INDIA'S ECONOMIC POLICY AND THE NECESSITY FOR A FINANCIAL MODEL

Rabea Förstmann / David Gregosz

Alongside China, India will play a decisive role in shaping the future world economic system - as a provider of goods and services and also as a consumer of these. As a result, the global flow of goods and capital will find new routes, ultimately shifting positions of economic power. The process of economic catching-up of recent years (with average growth rates of over eight per cent in the last four years), increasing self-assertion in the world's markets, and a young, fast-growing population¹ indicate that the world's largest democracy will take its place in the line-up of economic heavyweights. The two aspects - the economic potential and the as yet unsolved poverty problem - indicate the complex starting situation for a country that has been subjected to rapid economic changes in the last 20 years. These changes were brought about deliberately, if not always voluntarily, within the framework of a democratic state: following a balance of payments crisis in 1991, India's government implemented extensive economic policy reforms, including the removal of import taxes, a reduction of bureaucratic hindrances (improvements to the authorities and their structure, combating corruption, etc), and opening the country up for foreign investment.

Does this reform process disprove theories that democratic states are weak (due to the many powers of veto present in them) - or is it rather that India's structures offered only few possibilities for participation that could have influenced



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1 | Around 54% of the population of India is under 25 years of age. However, India's „demographic dividend“ is not without problems, as up until now there have not been enough jobs and training positions available for all of them.

the course of liberalization now under way? The latter seems more likely, and can be recognized by the fact that no public debate was held about the concepts and goals of Indian reform policies for a long time. At times, the lack of engagement with civil society - a stabilizing, consensus-building element in "rooted democracies" - led to frequent elections at the federal level, and with them, interruptions to the economic policy reforms. In the absence of a regulatory basis it was not possible to communicate plainly to the population what the overarching goal of particular decisions - such as the privatization of profitable state-owned enterprises - was intended to serve.

The present time would seem favorable for such reform, however, and not only because of the window of opportunity offered by the economic crisis. Since the last parliamentary election (to the Lok Sabha in April and May 2009), the Congress Party in India has led a coalition, the United Progressive Alliance (UPA), that no longer requires the support of the Communist Party of India (Marxist) [CPI(M)]. This means, in theory, that the way is now clear for decisive market-oriented economic reforms (including the systematic privatization of state-run enterprises and a restructuring of the tax system). In order to communicate economic reform concepts in a way that gains acceptance, it is helpful to relate them to an overarching political approach. At times this is indeed essential. But is the governing UPA coalition capable of developing such a model in order to bring even unpopular reforms into a larger context of justification? What could such a model look like, and is it possible to borrow from the German concept of a "social market economy"? We will address these questions below. Before this, however, we will look at Indian reform policies in past years. In the second part we will review developmental tendencies within the parliamentary system and also discuss the effects of the financial crisis on the Indian economy.

THE WAY TO INDIA'S MODERN ECONOMIC SYSTEM REASONS FOR THE FIRST LIBERALIZATION PERIOD FROM 1991

Until 1991, the year when extensive liberalization measures began, India was considered - in terms of its

regulations on the domestic economy, its customs and its quantitative trade restrictions – as one of the world’s most highly regulated national economies among democratic countries. Although capitalist structures had developed since independence from the United Kingdom in 1947, private companies were only tolerated if they followed centrally planned goals determined by the government.² An import substitution policy (causing separation from the world’s markets) and discretionary state interference were significant instruments of the socialist-interventionist government years from 1947 until the mid-1980s.³

It was only in the mid-1980s that the Indian government, under Indira and Rajiv Gandhi, was forced to make its first structural reforms – partly also under pressure from several large companies. This led in particular to domestic deregulation⁴ which amounted to a cautious turning away from the “quasi-socialist” system. However, these efforts for reform met with significant resistance from the population and also from some sections of the government apparatus, which is why few sweeping economic successes could be attained. Unlike the East Asian “Tigers”, India’s economic development was meager. The fact that economic growth (GDP) continued to increase in this period can be ascribed to the high level of state demand for goods and services. Not until the end of the 1980s could the political resistance to reform be overcome. By this time new political actors were entering the arena (as a result of a growing middle class), and changes in basic economic conditions led to a significant pressure for reforms.⁵

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The second Gulf War (1990/1991) led to a rise in crude oil prices, making one of India’s most important import goods suddenly more expensive. The national economy also lost

2 | cf. J. Khalilzadeh-Shirazi and R. Zagha, “Economic Reforms in India: Achievements and Agenda Ahead”, *The Columbia Journal of World Business* (1994), p. 26.

3 | cf. H. Müller and C. Rauch, “Indiens Weg zur Wirtschaftsmacht” [India’s Road to Economic Power], in: *Aus Politik und Zeitgeschichte* (2008), p. 8.

4 | cf. J.D. Pedersen, “Explaining Economic Liberalization in India: State and Society Perspectives,” in: *World Development*, 28 (2000), 2, p. 266.

5 | cf. J.D. Pedersen (2000), p. 275.

what was probably its most significant trade partner - and the equally important export profits – with the collapse of the Soviet Union.⁶ Because foreign currency reserves also quickly disappeared, delays of payments in international business trade could hardly be kept in check.

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India then had to apply for loan installments from the International Monetary Fund (IMF) which were bound to particular conditions,⁷ and the conditionality of these loans made extensive reforms unavoidable. Even if the government’s instruments in combating the crisis scenario outlined here had the character of individual measures, the successes achieved with the reform were remarkable: the “Hindu rate of growth”⁸ that averaged 3.5% 1980 and 5% in the 1980s was overcome and economic growth rates could be increased to long-term values between 6.9% (2003) and 8.7% (2009). There was however no debate in this phase about the actual economic policy goals of India.

INITIATIVES PROMPTED BY INDIA’S ECONOMIC POLICY REFORMS

Even if the initial “opening of the national economy” in 1991 only brought selective changes to the regulatory framework, it was still evident that India’s government under Prime Minister Rao wanted to change the existing paradigms. The Rao government signaled then that in future it would rely to a greater extent on market economy coordination mechanisms, further strengthen the core of private enterprise, and reform government bodies.⁹ All that was issued by way of a concrete target, however, was that honesty in taxpaying would be improved, the exchange rate made competitive and free trade permitted.

6 | cf. S. Li and A. Nair, “A comparative Study of Economic Reforms in China and India: What can we learn?” in: *Global Economic Review*, 36 (2007), 2, p. 154.

7 | cf. Pedersen (2000), p. 267.

8 | Indian economic scientist Raj Krishna coined the phrase “Hindu rate of growth” for 3.5% per annum. For a population growth of 2% p.a. this still meant approx. 1.5% growth for the per capita income per year.

9 | cf. M. S. Ahluwalia, “Economic Reforms in India since 1991: Has Gradualism Worked?”, in: *Journal of Economic Perspectives*, 16 (2002), 3, p. 1.

Although improved access for basic needs such as education and health also found its place in the Prime Minister's catalog of requirements,¹⁰ the implementation of these plans proceeded at a dragging pace. Some of the reform measures are outlined here:

- Reform in domestic regulation in India concentrated on industry and the banking sector. Today only three of the former 18 branches of industry remain totally state-owned (military equipment, nuclear energy, and rail transport).¹¹ Far less progress was made in the removal of regulations aimed at protecting small business structures¹²: from 1970 to 2002 only 64 of 800 sectors were released for possible involvement by larger (foreign) companies.¹³
- Reforms in the banking sector concentrated primarily on removing control of the interest rate by the central bank, the Reserve Bank of India (RBI), and no longer allowing the banks' lending rate to be determined by the RBI. Although the competitive environment was strengthened in the banking sector (through recognition of private banks), the need remains for a larger number of private competitors in order to reach the broad mass of the population in rural areas also. In addition, the foreign currency exchange controls need to be rethought, because they isolate foreign investors from the market. Since October 2007 it has no longer been possible to invest certain funds in shares, and a cash deposit obligation is in place.

10 | cf. J. Khalilzadeh-Shirazi and R. Zagha, "Economic Reforms in India: Achievements and Agenda Ahead", in: *The Columbia Journal of World Business* (1994), p. 25.

11 | cf. Indian Department of Public Enterprises (ed.), *Public Sector in India*, online at: http://dpe.nic.in/newpayrevision/Chapter-1-Overview%20&%20Profile_Final.pdf [20.3.2010].

12 | Small businesses are a significant part of Indian industry, both in terms of employment and manufacture. They enjoy special state support measures, and importantly, protection from competition from large companies. As a consequence of these "protective measures", work-intensive and often unproductive manufacturing methods have survived and rely on cheap labour.

13 | cf. M. S. Ahluwalia, "Economic Reforms in India since 1991: Has Gradualism Worked?", in: *Journal of Economic Perspectives*, 16 (2002), 3, 3. This regulation states that the investment volume for factories and equipment is not permitted to exceed US\$ 250,000.

- Privatization and liberalization of state monopolies began comparatively late.¹⁴ The insurance sector, for example, was not opened to private competition until 2000 - a process which remains uncompleted, as no cross-party consensus concerning the time horizon and extent of the privatization is yet forthcoming. As concerns the public perception, the sale, particularly of profitable state-run enterprises, had and has little support. A value-added tax was implemented only in 2005, for example.¹⁵ Probably the furthest-reaching tax reform was planned for 1 April 2010 with the introduction of the "Goods and Service Tax" (GST). The reorientation of the existing tax system and particularly the systematic taxation of services is expected to raise tax revenue and make the tax system more transparent. However, due to numerous delays, the introduction of GST will be postponed until at least October 2010.
- In the course of liberalization, India not only removed a massive body of regulations, but also opened domestic markets to foreign investors and global trade. Before the reforms of 1991 the importing of consumer goods was prohibited. Only capital goods, raw materials, and partially processed goods were permitted where no Indian equivalent existed. This restrictive licensing system for the import of capital goods and partially processed goods was at least partially abolished in 1993, a decision that was welcomed by industrial players because they could now manufacture at a lower cost and become more competitive. For trade in consumer goods, however, liberalization turned out to be prolonged - the last quantitative restrictions fell as late as 2001. The use of duties to restrict trade had been massively reduced since 1991.¹⁶
- A particular incentive for direct foreign investment was created in 1993 when foreign investors were allowed to buy shares traded on the stock market. Today companies

14 | Iron, steel, and other system parts were previously restricted to state manufacture. cf. N. Gupta, "Partial Privatization and Firm Performance", in: *The Journal of Finance*, 60 (2005), 2, p. 992.

15 | cf. Germany Trade and Invest (ed.), *Wirtschaftsdaten kompakt: Indien [Compact Economic Data: India]*, online at: <http://www.gtai.de/DE/Metanavigation/Suche/suche/UebergreifendGT.html> [20.3.2010].

16 | cf. J. Betz, *Informationen zur Politischen Bildung – Indien [Information on Political Education – India]* (Bonn: Bundeszentrale für politische Bildung [Bonn: Federal Center for Political Education], 2007), p. 48.

in India may be wholly owned by foreign investors. But such direct investments flow into applications oriented towards the Indian market, i.e. to domestic demand. Many product lines in the export sector are still reserved for the small-business sector and are not accessible to large foreign companies. Furthermore, India's export potential is hindered by substantial export duties, poor infrastructure and an inflexible labor market, in which it is almost impossible to fire employees in companies with over 100 staff. In order to shape the Indian economy's transformation process gradually while retaining a degree of control, India's capital balance remained closed at first, so that a large proportion of transactions required government approval.¹⁷

Summarizing the economic policy initiatives in India over the last 19 years gives an ambivalent picture: in some sectors, far-reaching resolutions were pushed through, while other areas require further restructuring. Thus the land reforms urgently needed for agriculture did not take place. This sector could profit only indirectly from the devalued rupee, improved foreign sales opportunities, and also from special programs such as the National Rural Employment Guarantee Act 2005 (NREGA), a program for reducing poverty. Also neglected was the adjustment of the infrastructure to the growing economy.

THE HORIZON OF REFORM EFFORTS AND THE ADJUSTMENT OF SOCIAL STRUCTURES

The liberalization process in India can be described as a policy of gradual transformation. Step by step, state-owned enterprises were privatized, quantitative trade restrictions reduced, and duties removed. An analysis of the prevailing political conditions and constellations of actors should now give an insight into the catalysts for these reform efforts. According to Li and Nair (2007), political realignments in democratic systems are being implemented more slowly and less stringently, since comparatively short periods in office have not created sufficient motivation for the pursuit of long-term reform goals in particular. In this respect, there is little logic in concentrating on a program of solely long-term aims. Politicians fear being voted out because

17 | cf. J. Khalilzadeh-Shirazi and R. Zagha, (1994), p. 27.

of their economic alignment. That is possibly one reason why emphasis has been placed on steering the attention of the electorate toward popular themes, such as the relationship between religion and the state.

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A consequence of the lack of economic policy goals can be observed as an estrangement between politics and business. This aspect was intensified by the hierarchical structure of Indian institutions: because of the “top-down” strategy applied in economic policy, there lacked a participatory approach even within the political elites.¹⁸ Moreover, there are still many voices in state institutions that demand a return to the socialist system.

THE PARTY SYSTEM IN TRANSITION: DEVELOPMENT TRENDS IN RECENT YEARS – PARTIES AND PARLIAMENTARY ELECTIONS SINCE 1991

Two clear trends may be discerned in India’s parliamentary elections since 1991. Firstly, the Congress party, which has governed almost without interruption since independence and whose strength often gives India the appearance of a one-party democracy, has lost voter support over an extended period.¹⁹ Second, many parties have appeared on the political scene, particularly at the federal level. While in 1989 the Congress party still won over 40% of votes,²⁰ by 1998 it could attract barely 26% of the vote²¹ and was thus no longer able to create a coalition capable of governing. Although its share of the vote has since increased again to 28%,²² approval for this party among the public has tended to sink nonetheless. This loss of votes can be mainly attributed to the now stronger BJP (Indian People’s Party) and the growing number of regional parties. A mirror-reflection of the decline of the Congress Party was the success of the BJP in raising its share of the vote from under 12% to 25% in 1998. However, in the last parliamentary election in early 2009, this share also

18 | cf. Rodrik (1996), p. 35.

19 | cf. L. Sáez, “The 1999 General Election in India”, in: *Electoral Studies*, 20 (2001), p. 166.

20 | cf. D. Butler und P. Jalan, “The Indian Parliamentary Election of 1989”, in: *Electoral Studies*, 9 (1990), 2, p. 148.

21 | For the election result of 1998 see L. Sáez (2001) and J. Betz (2007).

22 | cf. A. Sadanandan, “The parliamentary election in India, April–May 2009”, in: *Electoral Studies*, 28 (2009), p. 660.

fell sharply and now stands at about 18%. Comparatively small parties, which traditionally represent the interests of a particular region or caste, have so grown in importance at the national level as to be present in every governing coalition of recent years. Although this aspect shows the enduring significance of the caste system in India, it should equally be noted that the parties most able to attract votes were those that concentrated on the specific problems of a particular federal state. The political scientist Sadanandan (2009) even goes so far as to interpret India's parliamentary elections not as a national competition for votes, but rather as a multiple contest among numerous players, fought out at the federal state level. The election results appear to be influenced primarily by regional, i.e. federal state, dynamics and not by national developments.

A glance at the agendas for parliamentary elections of the last 20 years indicates what a small role economic policy issues have played. This is certainly in contrast to the significance of these topics during the election period.

INCREASING REGIONALIZATION

The increasing regionalization of recent years can partly be ascribed to the disillusionment among voters concerning their power to influence national politics, and their change of focus to regional problems - a phenomenon of which the size of the Indian subcontinent is also surely a factor. Nevertheless, India's political system can now be regarded as stable; the last two governments completed their full five-year periods in office. However, the coalitions are less stable in themselves and there is a danger of national policy becoming no more than an aggregation of local and regional policies.

An increase in regionalization²³ is problematic in that it is increasingly robbing politics of its long-term time horizons, since the interests of parties and citizens are in danger of becoming lost in policy areas that are of little political relevance for India as a whole. Because the regional parties may be less certain of reelection than the

23 | A possible change of direction in this regionalization process could be detected in the latest elections. For the first time in years, a party – the Congress party – clearly gained approval, cf. Konrad-Adenauer-Stiftung: www.kas.de/Indien.

now re-strengthened Congress party, they have a strong incentive to ignore the future consequences of their current political course. This often comes down to a combination of tax cuts and increased expenses that is fatal for budgetary policy.²⁴ Changes of direction in economic policy, which could guarantee India permanent increases in the future, have been forced further and further into the background. Measures and regulations oriented toward sustainability, which place stronger obligations on India's politicians and governments to hold to the decisions of their predecessors, would be desirable in order that long-term reforms are also implemented.

THE 2009 ELECTIONS: A VOTE FOR MARKET ECONOMICS REFORM POLICY?

Indian voters set a clear signal in the parliamentary elections of 2009 by settling more distinctly on a single party than in previous years. The election result is generally interpreted as a generational change and as a signal from India's young population.²⁵ Almost 29% of votes fell to the Congress party, which together with its coalition partners now has a total of 262 votes in parliament. This is only 10 votes less than is necessary for an absolute majority. By contrast, voters gave a clear rejection to the left and right-wing populist parties. The Communist party also won fewer votes than in the previous election of 2004, and is no longer part of the coalition alliance.

Privatizations to the value of 250 billion rupees have already been announced by the new government for 2010. Additionally, at least 10% of shares in companies with a government stake of over 90% are to be sold.²⁶ The room for maneuver offered to the United Progressive Alliance by the non-participation of the Communist party could enable the elimination of the massive state deficit. However, this will only be possible if the economic measures triggered by

24 | K. Chaudhuri and S. Dasgupta, "The Political Determinants of Central Governments' Economic Policies in India: An Empirical Investigation", in: *Development*, 17 (2005), p. 959.

25 | Bundeszentrale für politische Bildung (ed.), "Parlamentswahlen in Indien. Hintergrund aktuell vom 28. Mai 2009" [Parliamentary Elections in India – current background as at May 28th 2009] online at: http://www.bpb.de/themen/QZT8WD,0,0,Parlamentswahlen_in_Indien.html [20.3.2010].

26 | *Handelsblatt*, 20.01.2010.

the global financial crisis lead back to a sustainable path of growth, and potential income from the sale of shares is used to consolidate the budget. Beyond this, income from privatization is urgently needed for the planned infrastructure measures by 2012. It is nevertheless unlikely that the Singh government will institute a rapid reform policy. Once again the government is seeking to avoid selling profitable enterprises outright and recently announced that at least 51% of shares should remain in state ownership²⁷ - a decision that is likely to displease the emergent middle classes, since these rely on the government steering a market economy course. On the other hand, the interests of the population in rural areas are quite different. The benefits of further steps towards liberalization must therefore be made especially clear to this group. One approach, for example, would be to use the profits from the sale of state-owned enterprises directly for the establishing or expansion of the social system, and to communicate this fact. This is the only way to prevent the rural population from withholding its loyalty and voting the government out there and then.²⁸

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ECONOMY AND POLITICS: A LATENT TENSION IN INDIA

The restructuring of the economy was implemented almost completely from the top down and not as a participatory process. Although, as already mentioned, a middle class emerged as early as the 1980s, in which consumerism played an increasing role, nevertheless politicians and broad swathes of the rural population remained attached to old views of economic policy focused on subsidies and isolation. Only in the late 1990s, a time when economic policy issues were gradually finding their way into election campaigns and a growing number of regional parties was gaining influence, did the public attitude towards market economy reforms change. One reason for this, although not decisive for the elections, was probably the fact that the Indian electorate professed its desire for such reforms

27 | cf. *Handelsblatt*, 15.06.2009.

28 | J. Betz (2007), p. 49

in the 2009 elections by voting the Communist party out, to give further legitimacy to the liberalization processes.

THE GLOBAL ECONOMIC AND FINANCIAL CRISIS AND ITS EFFECTS ON THE INDIAN SUBCONTINENT

In 2008, when the effects of the global financial and economy crisis became clear, investors, companies, and consumers worldwide hoped that India and China could act as a buffer to at least partially compensate the collapse of global demand. There were several reasons for this. New studies

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have shown that, despite the growing inter-dependence between national economies, developing and emerging countries still follow different economic cycles to those of industrialized nations.²⁹ GDP and productivity had risen successively in recent years in all the “emerging markets”, and the per-capita income - still markedly lower - allowed hope for a catch-up process which would maintain the demand for both products and services.

Moreover, Indian investors had invested relatively low sums in bonds or investments supported by subprime mortgages - of India's financial sector, with a value of US\$500 billion, only US\$1 billion flowed into toxic shares. The fact that the Indian rupee is not yet fully convertible (export of currency reserves is not unlimited) and that the capital balance is only being opened up slowly (Indian interest rates up to now remain clearly higher than the international level) have had a positive effect during the crisis. High currency reserves were a further characteristic of the Indian economy to initially create a good starting basis for the country in the crisis.³⁰

The extent to which India had become integrated in to the global financial and economic structure over the past 19 years was however underestimated. One indicator of this is the growing correlation of Indian securities prices with global share prices. In particular, the boom in the

29 | cf. J. Ghosh and C.P. Chandrasekhar, “The cost of coupling: The global crisis and the Indian economy”, in: *Cambridge Journal of Economics*, 33 (2009), p. 725.

30 | cf. D. Alex, “The state of the Indian Economy 2009-10”, in: *Indian Council for Research on International Economic Relations*, Working Paper 241.

first years of the new millennium may be interpreted as a direct consequence of a close interlocking with the global economy. A process that has made India more susceptible to external shocks, despite the undeniable advantages, i.e. increased prosperity. Financial deregulation and the interweaving with foreign capital markets (external transactions have doubled in recent years³¹), in particular, gave rise to a credit boom driven by sections of the population with medium and high incomes.

As a result, India too was hit in January 2008 by the rapidly spreading crisis, having experienced steady growth year on year until that time.³² Exports could not absorb falling domestic demand, and international investors, who were attracted before the start of the crisis by high growth expectancies and tax advantages, withdrew their trust from India's national economy. After a relatively short time, the crisis was also noticeable in the labor market - especially in the few key industries.³³ In total, twelve million Indians are estimated to have lost their jobs in the crisis - a factor which has further diminished India's already numerically small middle class.

India's export and import sector was influenced in several ways, and it became clear in particular that its concentration on a small number of trading partners and the resultant dependences are a major weakness. With the collapse of global economic growth and the associated fall in demand, the decline in India's goods exports was stark. Since almost 12% of India's exports went to the USA, for example, the fall in demand in the USA impacted significantly on India's goods exports. Export of services was also negatively affected, primarily by the falling value of the US dollar. Some 60% of the profits recorded by India's technology industry in previous years were generated in the USA. As a result, India's foreign trade balance deficit rose to US\$133.8 billion during the crisis (2008).

31 | cf. D. Subbarao, "Impact of global financial crisis on India - collateral damage and response," Speech in Tokyo on 18.02.2009.

32 | For current economic data, see Germany Trade and Invest (2009).

33 | cf. K.P. Kannan, "National Policy Responses to the Financial and Economic Crisis: The Case of India," (2009), p. 1.

As already indicated, India's capital market has incorporated itself more strongly into the global environment in recent years. Owing to high rates of growth and positive predictions for the future, high capital imports took place prior to the crisis (9% of GDP). Immense currency reserves were piled up, which were increasingly necessary to finance the foreign trade balance deficit. Because international investors wanted to use investments in India as global hedges, a large proportion of foreign investments in India took the form of portfolio investments (investments in shares, not material assets). This made India's capital markets vulnerable to the mood of the investors, since capital investments of this type can be quickly retracted. The inflow of international capital put pressure on the rupee to rise in value, which in turn had a negative effect on the competitiveness of the export sector. It also led to a further flow of speculative capital. In the course of the crisis and the scarcity of credit in the USA, many investors pulled capital out of India. This was followed by the collapse of the Indian shares market and a strong downward trend in the exchange rate of the rupee. Due to the growing foreign debt, there was an increasing demand during the crisis for currency. Interest rates in India thus came equally under pressure and increased.³⁴

The government of Prime Minister Manmohan Singh reacted to the crisis comparatively late and adopted the first stimulus package in December 2008. By international comparison it proved relatively small, amounting to 0.5% of GDP. Two further economy packages followed in January and March 2009, which mainly provided for additional public expenditure, high-priority infrastructure measures,³⁵ and support for export industries. In addition, indirect taxes were lowered and budget consolidation policy goals postponed.³⁶ However, in total these three measures only accounted for about 1.8% of Indian GDP and, according to projections, only absorbed 20% of the external shock.³⁷ The fact that these fiscal crisis actions

34 | cf. J. Ghosh and C. P. Chandrasekhar (2009), p. 730.

35 | cf. B. Herzog, *Die soziale Marktwirtschaft als guter Ratgeber im Krisenmanagement der Bundesregierung [The social market economy as a good advisor in crisis management for the federal government]* (Berlin: Konrad-Adenauer-Stiftung, 2008).

36 | cf. D. Subbarao (2009), p. 9.

37 | cf. D. Alex (2009), p. 26.

did not turn out higher can be ascribed to the very narrow room for maneuver owing to the Indian national deficit.

It was the high level of debt that made monetary measures the focus of the efforts. The primary goal was to sustain the functioning of the domestic money and capital markets and to ensure comfortable liquidity for the rupee and the currency reserves. To achieve this goal the Indian central bank changed its strategy, which up until August 2008 had been oriented toward tightening the money supply in order to combat high rates of inflation. The base rate was reduced step by step between October 2008 and April 2009, refinancing options for exporters were simplified, and more foreign borrowing was approved. Although these measures led to stabilization in the financial markets, at the same time they led to a massive increase in liquidity (7% of GDP).

The interventions of the government and the central bank were primarily driven by the strong effects that the significantly lower economic growth was having on production and employment. The government accordingly tried to compensate for the collapse of demand with its own state investments, but its options were greatly limited by the budget deficit. It was also the case that an additional capital flow from abroad would pressurize the central bank to restrict the money supply. Foreign loans to finance infrastructure projects would allow the spiral of debt to shoot ever higher.

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Although the situation for India's government was certainly difficult from a budget policy viewpoint, some of its interventions may be assessed critically. Important areas where spending was necessary were neglected - for example, improvements in the housing situation and reform in the social insurance systems. Because "political economic cycles"³⁸ can also be observed in India, one tends to conclude that priority in the crisis measures was given not to creating impulses for growth but rather to a pandering to specific groups of voters. This is corroborated by the fact that the stimulus packages were agreed up to March 2009; parliamentary elections were due in May.

38 | cf. K. Chaudhuri and S. Dasgupta (2005), p. 961.

The government's management of the crisis makes it clear that India's business sector and political base frequently differ on their ideas for further development of the economic system. While many companies would welcome a stronger market economy rate, India's government is deliberately slowing the rapid pace of liberalization. The tension between the players is a burden on India's competitive ability, along with the other problems yet to be discussed. However, the reelection of the

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UPA could be used to dissolve these tensions. It is therefore important to change not only the formal environment by legislation, but also the attitude patterns of society (toward freedom, self-responsibility, and solidarity) through careful communications. The lack

of debate over the last 20 years has prevented this from occurring sufficiently successfully. Currently an assortment of apparent, actionistic measures is preventing the establishment of an overall concept for economic policy that can justify unpopular reforms, such as that of the employment market.³⁹ Some of the challenges for India's reform policy may be briefly discussed below.

The slow growth of employment opportunities in industry and manufacturing poses a major challenge for India. Together with the protective measures in many areas of the small business sector, these regulations create significant access limitations for businesses as well as for employees.⁴⁰ But the positive long-term effects which would result from a renewal of the employment market laws are not known to many population groups. As we have already described in detail, politicians therefore fear the loss of votes. An economic policy discussion on goals and options in India would be desirable and effective in finally raising the acceptance of unpopular measures. Only these reforms could enable the creation of more jobs in the long term and make possible a payout from India's "demographic dividend."

39 | S. Ghosh and V. H. Devaiah, "A critical discussion of the disinvestment/privatization process in India since the start of the economic reforms in 1991", in: *Journal of Asian Public Policy*, 2 (2009), 2, p. 229.

40 | cf. A. O. Krueger, A.O., "The Missing Middle", *Indian Council for Research on International Economic Relations*, Working Paper, No. 230.

Further negative developments in India are the persistently high rate of poverty (480 million Indians live below the poverty line of US\$1.25 per day) and increasing social separation. As shown by the elections in 2004 and 2009, these topics are of particular significance for the public and are often described as the "Achilles' heel" of India's economic policy.⁴¹ This is why it is important to take targeted actions to foster social cohesion and reduce poverty; India's social structure, with its estimated 3600 castes and sub-castes, as well as large interregional differences in levels of economic activity, presents a major challenge.

A further problem in the social area arises from India's economic structure. Because the country only possesses a weak industrial base with insufficient employment opportunities (the service sector cannot close this gap), there lacks a strong, consumption-oriented sector of society.⁴² In Germany it is this sector that forms the backbone of political, economic, and social life. Further problems may also be mentioned here: the expansion of India's infrastructure often lags behind its economic development. This situation prevents economic activities being taken up by the sections of the population living in poverty.⁴³ Entrepreneurs, in particular, request the State repeatedly to create a more friendly climate for investors.⁴⁴ The tempo of investment is often very slow, and state monopolies, with their inflated prices and inefficient structures, have a negative influence on economic development.

The government's management of the crisis makes it clear that India's business sector and political base frequently differ on their ideas for further development of the economic system. While many companies would welcome a stronger market economy rate, India's government is deliberately slowing the rapid pace of liberalization.

41 | cf. O. Ihlau, "Indien auf dem Sprung zur Weltmacht [India on the threshold to world power]", in: *Aus Politik und Zeitgeschichte [From Politics and History]*, 22 (2008), p. 3 et seqq.

42 | cf. S. D. Sharma, "Dealing with The Contagion: China And India In The Aftermath Of The Subprime Meltdown", in: *China and World Economy*, 17 (2009), 2, p. 6.

43 | cf. P. B. Anand (1999), p. 737.

44 | cf. M. S. Ahluwalia, "Economic Reforms in India since 1991: Has Gradualism Worked?" *Journal of Economic Perspectives*, 16 (2002), 3, p. 4.

HOW COULD A MODEL LOOK? GERMANY'S SOCIAL MARKET ECONOMY AS A SUCCESSFUL EXAMPLE

The election in 2009 clearly shows the central values of the majority of the population: the fight against poverty and the creation of a society of opportunities (with opportunities for adequate health care, social security, education, jobs, etc.) must take center stage in India's government policy. Ludwig Erhard, Germany's first economics minister after World War II, had exactly the same goal. His maxim

was "Prosperity for All", and this could also be the working title for India's newly elected government. His orienting question was: how can an economically and socially more dynamic community be established, in which qualitative prosperity, employment, and justice are not irreconcilable opposites? This question also faces the Indian government –

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especially with regard to the rural poor. Ludwig Erhard was convinced that an economic system worthy of humanity can only be established by taking central principles into account: self-responsibility, just reward for performance and participation, competition, and the subsidiarity of social security were defined as core elements such an economic system. This concept gave rise to the concept of a "social market economy."

The first element of the social market economy is the securing of individual freedom. These rights to freedom reach their limits at the point where the rights of others, the constitutional order, or the moral law are infringed. As beings gifted with freedom, humans require no paternalism from the state and can make decisions from self-determined initiative. They must be empowered to do so wherever this is possible. Applying this to the field of economics, this means ensuring free competition on the markets, because only a competitive economy creates the conditions for growth and prosperity, as well as guaranteeing the material basis for life. However, such competition requires rules, applied by an effective competition authority. A policy oriented toward the "free play of market powers" leads, as experience shows, to the formation of

cartels and to fusions, takeovers, and to a suppression of competitors. This tendency, inherent in a market economy, reduces freedom and also creates undesirable side-effects for the national economy.

This fact was known to the instigators of the social market economy. As early as the 1930s, system theory experts pointed out that the market on its own does not create the order function ascribed to it by classic liberalism. They shared the opinion that state regulations are required to link the practicing of individual freedom with the interests of others and the community, and attributed particular importance to the state for ensuring freedom and competition. The initiators of the social market economy were also well aware that there are areas that a market economy cannot coordinate, in which the state must therefore be active (e.g. education, family support, and security from existential life risks, etc.) Similarly, areas exist in which prices are not set correctly or where problematic market solutions arise, again in connection with the provision of public goods. This basic orientation of Germany's economic policy has proved itself over the past sixty years and also prevented greater setbacks over the course of the financial and economic crisis. It could be an example for India's future economic policy to be set by the government established in 2009, as it supplements the desire of the fathers of liberalization for Prime Minister Rao to create a free market economy with an appropriate state regulatory system.