

Economic Times Exclusive: HARVARD PUNDITS RESET THE AGENDA
10 February 1999
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A New Social Contract Needed for India

*We have much to learn from China about rural reforms, say **Nirupam Bajpai and Jeffrey Sachs***

IF one puts the matter crudely, rural India's population is getting, the infrastructure that it is paying for- in other words, almost none.

Or to paraphrase an old quip from the former Soviet Union, the Indian population pretends to pay its bills, and the Indian government pretends to provide the services.

This is especially true in the rural areas, where water; power, telecommunications, and roads, are generally provided without cost or at least with deep subsidy, and as a result are almost not provided at all, since both the Union government and the state governments are short of cash. Even when charges are levied on public services such as water or electricity, the bills are often unpaid.

Rural India needs a new social contract, in which there will be a reliable infrastructure supplied at commercial prices rather than given for free.

The Government's commitment, both at the National and State level should be that every village will be assured at least minimal telephone service, clean water, a road to the regional market, and reliable power; but that every village will be responsible for covering the commercial' costs of those services on a normal user-fee basis.

Recent technological changes in each of these areas (telephony, water, road building and maintenance, and power) allow these key sectors to be organized, at least in part, on the basis of competitive, private- sector producers, who will provide the initial financing of the investments in return for a reliable stream of user charges over time.

In telephony, for example, microwave transmission (via cellular or satellite-based transmission) will allow low-cost commercial provision of telephone service to rural areas in ways not possible just a few years ago.

As a result of massive worldwide deregulation and privatization of telecommunications, combined with technological changes, fixed-line telephony is being overtaken by microwave and satellite telephony. Worldwide experience has shown that these services are best provided by competitive private carriers rather than a state monopoly. In power; the regulatory trick has been to separate power generation transmission, and distribution. Generation can be provided by competitive private producers, who then sell their electricity into the common transmission grid. The grid itself must continue to be regulated: by the government to ensure fair access of independent power producers.

India has so far made little progress in commercialising the. key infrastructural sectors. In power, for example, most electricity continues to be a public sector monopoly, run by state electricity

boards (SEBs). The SEBs are responsible for generating and distributing power, setting tariffs, and collecting revenues. Almost all of the SEBs make losses and some are even unable to pay for coal or the power they purchase. This is due to the fact that SEBs implement social subsidy policies of state governments leading to inefficient patterns of energy consumption, and even to non-recovery of their own costs. Also, there is considerable theft of power from the distribution networks. Power capacity will not be expanded until the SEBs are fundamentally overhauled or eliminated.

Even private power projects currently are expected to sell their electricity to the SEBs as their only power purchaser, so that the bankability of private sector power projects depends fundamentally on the financial health of the SEBs. Given the huge losses they make, and the large debts they owe to the National Thermal Power Corporation (NTPC), we cannot expect substantial private sector investment in the power sector, unless state governments implement major SEB reforms.

The basic sources of trouble are clear. Since SEB electricity charges are set much below cost for the agricultural sector, unit revenue realisation from the agricultural sector in none of the SEBs covers a reasonable fraction of the unit average costs incurred by the SEBs.

As a result, the SEBs make huge losses and are in financial disarray. In addition, the substantial theft from the power grid, placed around 21 per cent, makes matters worse. SEBs have huge payment arrears which they owe to the NTPC - from whom they buy power.

Over the years, the outstanding balances due to the NTPC from the SEBs have risen to Rs 49.5 billion, of which Uttar Pradesh, Delhi, Bihar, and Madhya Pradesh account for the bulk of the dues.

According to the revised estimates of 1996-97, in absolute terms, the commercial losses of the SEBs stood at Rs 109 billion. The hidden subsidy for the agriculture and domestic sectors has increased from Rs 72 billion in 1991-92 (1.2 per cent of GDP) to Rs 192 billion in 1996-97 (1.4 per cent of GDP) and is projected to further go up to Rs 215 billion in 1997-98 (1.5 per cent of GDP).

The state governments come to the rescue of SEBs by providing them with revenue subsidy along with capital transfers, which include loans and equity. The present structure of tariffs in electricity, involving extensive cross subsidisation for agriculture, has imposed a disproportionate burden on customers who actually pay their bills.

This, in turn, has led to a decline in consumption of power by high-tension users, with further serious financial consequences for the SEBs. With the present level of technical and organisational performance, most SEBs are losing about 50 paise, to 1 rupee for every kw/hr of power sold. There is hardly any capex operation and maintenance (O&M) expenses and the SEBs seriously lack managerial direction. Tariff reform, i.e. higher prices actually collected on electricity use, is the first order of business.

Privatisation of power generation, and the conversion of SEBs from electricity providers to market regulators would come next. The availability of infrastructure services, such as power, telecom, and roads in rural India can significantly help develop rural industry in India.

Lessons from China are once again relevant here, especially the boom in China's Township and Village Enterprises (TVEs). These are a mix of collective and privately owned enterprises in rural China. The TVEs operate outside of the state plan, and largely, without funds from state banks. Therefore, they are subject to quite rigorous market competition and hard budget constraints.

China's experience demonstrates that establishment of small townships to link the countryside with the urban areas is a successful strategic policy for development.

This will facilitate the transportation of goods between rural and urban areas, and rising income and productivity in rural areas. As for urban enterprises, this link would open up a bigger market and help in diversification or restructuring, which is currently under constraint due to area limitations.

Rural enterprises can also compete in the cities with their products having the advantage of relatively low labour costs.

In this way, they will help absorb surplus labour locally, thereby resulting in less rural-to urban migration (population in urban areas, and especially in larger cities, such as Calcutta, Chennai, Delhi, and Mumbai have reached levels far above what these cities can efficiently accommodate given their capacity to provide urban infrastructure services).

Urban enterprises will also provide more employment opportunities since they would have a larger market. In addition, the linkage will benefit the rural industries via. flow of technology and information.

Third Prong: Macroeconomic Stability - The Asian crisis highlights the vulnerability of even the most successful economies to macroeconomic instability.

Perhaps it is even more accurate to say that the most successful economies run the risk of a special kind of macroeconomic stability, a kind of crisis of success.

While the East Asian crisis is sometimes characterised in the world press as a massive failure of Asian capitalism, it is more accurate to say that it is a failure of global capitalism to provide for a smooth and reliable flow of capital from the capital-rich to the capital-poor regions. And that failure is most acute in fast growing economies.

India, therefore, must combine its growth strategy with a special attention to the preservation of macroeconomic stability. To understand the macroeconomic policy challenges facing India, we must first understand the East Asian crisis.

The East Asian countries that are now in crisis are suffering from an abrupt reversal of capital flows that began in mid-1997. Consider the five hardest hit countries: Indonesia, Korea, Malaysia, the Philippines, and Thailand. These five countries received \$230 billion of net private capital flows during the period 1994-96. In 1996 alone, they received \$93 billion of net flows. When the Thai baht was devalued in mid-1997, however, the euphoria in world markets that had led to the massive inflows, suddenly turned to panic and massive capital outflows.

An estimated \$12 billion of net outflows occurred in 1997 as a whole, all concentrated in the second half of the year. The net reversal of flows of \$105 billion represented approximately 11 per cent of the pre-crisis GDPs of the five countries, in other words, an absolutely massive and sudden shock. Much of the reason for the panic resulted from the form of the original lending.

A huge proportion of the capital inflow came in the form of short term loans from international banks.

The international banking system had lent the five Asian countries roughly \$230 billion in total loans as of mid-1997, of which around \$150 billion had a maturity of under one year. These short-term debts were larger than the combined foreign exchange reserves of the five countries, which totaled approximately \$120 billion as of mid-1997.

Because the short term liabilities exceeded the short-term assets; the Asian-5 countries were subject to a financial panic. Each investor posed himself a question. Suppose that all the other investors decide to withdraw their short-term loans. Will there be enough foreign exchange available to make good on my loan as well when it comes due?

Clearly, if each investor comes to believe that all the other investors will withdraw their loans, it becomes rational to call in one's own loans as well, indeed ahead of the other creditors. A rational panic ensues, in which every investor scrambles to be the first one out of the country.

The Thai baht devaluation provided the impetus for the panic. Interestingly, certain kinds of money fled, while other kinds did not. This gives guidance for macroeconomic policy management.

The hottest money was short term loans from international banks. Indeed, the reversal of short term bank lending constituted a very large proportion of the overall \$105 billion reversal in capital flows. The banks put in \$ 56 billion in net lending in 1996, and then withdrew an estimated \$21 billion in net loans in 1997, for a swing of \$77 billion (or 73 per cent of the overall reversal). Portfolio equity investors (e.g. country equity funds) also reversed gear, to the extent of \$24 billion. Foreign direct investors, by contrast, were very stable. It is estimated that net foreign direct investment remained roughly unchanged between 1996 and 1997, at around \$7 billion in net flows each year.

Here are some of the pertinent lessons for macroeconomic management. First, beware of the reliance on short term inflows. Such short term capital is fickle. India has benefited since the early 1990s in keeping a regulatory restraint on short term borrowing from abroad, after the brush with financial disaster in 1991 (which involved the reversal of short-term capital flows of the so-called non-resident Indian accounts).

There is simply no good case for allowing domestic banks to expose themselves to amounts of foreign debt, especially short-term debt. Second, policymakers should keep an eye on the crucial ratio of short-term debt to foreign exchange reserves. Markets will be subject to panic when short-term reserves dip below short-term debts.

Again, India has looked rather good on this score in the recent past. With reserves around \$25 billion, and short-term debts to international banks around \$ 8 billion, and therefore a ratio of short-term debt of reserves around 30 per cent (as opposed to the greater than 100 percent in the East Asian crisis countries), India has been able to avoid a self-fulfilling panic. Third, India should act with considerable care in the liberalisation of financial markets. This is not an argument to avoid needed reforms, but to sequence them in an appropriate manner.

Certain reforms should come early. Currency convertibility on current account transactions can be introduced immediately (as was done successfully in Poland, for example, in 1990), since this merely establishes the financial mechanism for free trade. Similarly, the doors should be thrown wide open to foreign direct investment. FDI brings huge advantages (new capital, technology, managerial expertise, and access to foreign markets) with little or no downside. FDI flows tend to be cyclical, or sometimes, even counter-cyclical. Financial institutions should be pressed to raise capital in order to put a larger cushion in the financial system against the kind of banking calamities now hitting the East Asian countries. Undercapitalised banks are simply an invitation to banking misbehaviour and a heightened risk of banking collapse:

State banks should be privatised, with an explicit aim of bringing in long-term foreign investors into the banking sector. Another lesson from East Asia is that there are significant advantages to a large presence of foreign owners in the banking system. Foreign capital in the banks provides another cushion against banking collapse.

For example, when the Indonesian banking sector collapsed in November 1997, the only banks that remained functional were the branches of international banks. Fourth, India should avoid another of the serious mistakes of several East Asian countries, most notably Korea, the Philippines, and Thailand.

These countries pegged their currencies to the US dollar in the early 1990s, then experienced inadvertent and sharp currency appreciation vis-à-vis Europe and Japan when the dollar strengthened after 1995, and then ran', down foreign exchange reserves vainly trying to defend the over valued exchange rate when market sentiment turned against the currencies in late 1996 and the first half of 1997.

By spending reserves in a failed defence of the currency, the Central Banks also left their economies exposed to subsequent financial panic when short-term debts came to exceed the dwindling level of foreign exchange reserves. In the end, the currencies collapsed anyway, but only after a deep financial crisis had already gotten underway.