# PREFACE

In the curricular structure introduced by this University for students Post-Graduate degree programme, the opportunity to pursue Post-Graduate course in a Subject is introduced by this University is equally available to all learners. Instead of being guided by any presumption about ability level, it would perhaps stand to reason if receptivity of a learner is judged in the course of the learning process. That would be entirely in keeping with the objectives of open education which does not believe in artificial differentiation. I am happy to note that the University has been recently accredited by National Assessment and Accreditation Council of India (NAAC) with grade "A".

Keeping this in view, study materials of the Post-Graduate level in different subjects are being prepared on the basis of a well laid-out syllabus. The course structure combines the best elements in the approved syllabi of Central and State Universities in respective subjects. It has been so designed as to be upgradable with the addition of new information as well as results of fresh thinking and analysis.

The accepted methodology of distance education has been followed in the preparation of these study materials. Co-operation in every form of experienced scholars is indispensable for a work of this kind. We, therefore, owe an enormous debt of gratitude to everyone whose tireless efforts went into the writing, editing and devising of a proper lay-out of the materials. Practically speaking, their role amounts to an involvement in 'invisible teaching'. For, whoever makes use of these study materials would virtually derive the benefit of learning under their collective care without each being seen by the other.

The more a learner would seriously pursue these study materials, the easier it will be for him or her to reach out to larger horizons of a subject. Care has also been taken to make the language lucid and presentation attractive so that they may be rated as quality self-learning materials. If anything remains still obscure of difficult to follow, arrangements are there to come to terms with them through the counselling sessions regularly available at the network of study centres set up by the University.

Needless to add, a great deal of these efforts are still experimental—in fact, pioneering in certain areas, Naturally, there is every possibility of some lapse or deficiency here and there. However, these do admit of rectification and further improvement in due course. On the whole, therefore, these study materials are expected to evoke wider appreciation the more they receive serious attention of all concerned.

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Vice-Chancellor

**Netaji Subhas Open University**
**Post Graduate Degree Programme**
**MA in Economics**
**Course : Indian Economy-II : Reforms and Contemporary Issues**
**Code : PGEC-VII**

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# Netaji Subhas Open University
**Post Graduate Degree Programme**
**MA in Economics**
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PG : Economics
(PGEC)

## PGEC-VII : Indian Economy-II Reforms and Contemporary Issues


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# Unit - 1 ❑ Indian Economy on the Path of Reforms

**Structure**

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## 1.1 Objectives

After reading this unit, you will be able to :

- Understand the rationale behind the economic reforms in India;
- Also understand the political aspects of reforms; and
- Have a comprehensive understanding of the typology of reforms undertaken in different sectors of the economy such as fiscal reforms, trade liberalization and industrial policy reforms, public sector enterprises reform, and the most important one like financial sector reforms.

## 1.2 Introduction

The immediate factor that triggered India's economic reforms of 1991 was a severe balance of payments (BoP) crisis that occurred in the same year. The first sign of BoP crisis became evident in late 1990s, when foreign exchange reserves began to fall. With the onset of the Gulf War, world oil prices starting increasing, and remittances from Indian workers in the Gulf region fell sharply as many of these workers left the region. From a level of US $ 3.11 billion at the end of August 1990, foreign exchange reserves dwindled to $ 896 million in January 1991.The rapid loss of reserves prompted the Indian government to initially tighten restrictions on the importation of goods.

Besides, unstable coalition politics at the Centre compounded the economic problems and hastened a full-fledged BoP crisis. However, it was increasingly clear by the beginning of 1991 that import compression by limiting the imports of capital and intermediate goods, was restricting the rate of economic growth and of exports. Furthermore, it was evident that the payments crisis was no longer primarily due to the trade deficit, but was driven by adverse movements in the capital account, in particular the drying up of commercial loans by the Non-Resident Indians, reflecting a loss of confidence in the government's ability to manage the BoP situation. The new governments of Prime Minister P. V. Narasimha Rao, assumed office in June 1991, moved swiftly to deal with the situation. It implemented a macro stabilization programme along with structural adjustment on an urgent basis, along with a comprehensive and far-reaching overhaul of the policies governing India's international and industrial sectors.

## 1.3 Rationale of Economic Reforms in India

The decision to embark on the reforms following the crisis of 1991 was primarily motivated by the beliefs of former finance minister Manmohan Sigh that the roots of the financial crisis were structural in nature and lay in import substituting industrial strategy (ISI) followed by the India's governments since 1947. The main elements of this ISI strategy were inward-looking trade and foreign investment policies along with excessive bureaucratic controls over production, investment, and trade, and a substantial public sector presence in the economy, going beyond the conventional confines of public utilities and infrastructure. The strategy of heavy

industrialization based on import substitution is believed to have hampered growth in various ways. First, the divergence of domestic from international price ratios to which the protection of domestic industry has led is believed to have caused a misallocation of resources, leading for instance to the recorded sharp rise in the capital-output ratio. Secondly, by constraining the growth of imports of intermediate and capital goods, inward looking policies are responsible for the failure to seize export opportunities, resulting in capacity underutilization and technological retardation, as well as a continuing foreign exchange shortage.

The trade regime was highly restrictive, as nearly all imports were subject to discretionary import licensing or were channeled by government monopoly trading organizations. The only exceptions were commodities listed in the Open General Licenses (OGL) category.

Regarding industrial policy, the two key components of the regulatory framework were the Industries Development and Regulation Act of 1951 and the Industrial Policy Resolution of 1956. The first piece of legislation introduced the system of licensing for private industry. The licensing system governed almost all aspects of firm behavior in the industrial sector, controlling not only entry into an industry and expansion of capacity, but also technology, output mix, capacity location, and import contents. The principle aim of this act was to channel investments in the industrial sector in "socially desirable directions".

The system of controls was reinforced in the 1970s with the introduction of MRTP Act in 1970 and the FERA in 1973. The MRTP Act stipulated that all large firms (those with a capital base of over 20 million rupees) were permitted to enter only selected industries and that too on a case-by-case basis. In addition to industrial licensing, all investment proposals by these firms required separate approvals from the government. The FERA provided the regulatory framework for commercial and manufacturing activities of branches of foreign companies in India and Indian joint-stock companies with a foreign equity holding of over 40%.

The industrial licensing systems, in conjunction with the import licensing regime, led to the elimination of the possibility of competition, both foreign and domestic, in any meaningful sense of the term. As it became increasingly complex over time, it led to a wasteful misallocation of investible resource among alternative industries and also accentuated the underutilization of resources within these industries, thus contributing to the high levels of inefficiency in the industrial sector. As Jagdish Bhagwati (1993) noted," the industrial-cum-licensing system... had degenerated into

a series of arbitrary, indeed inherently arbitrary, decisions where, for instance, one activity would be chosen over another simply because the administrative bureaucrats were so empowered, and indeed obligated, to choose." Indeed, industrial policies placing limits on the creation and expansion of capacity through the licensing system are believed to have increased the degree of monopoly by erecting barriers to entry for new firms, creating an environment where there is no pressure on manufacturers to reduce or improve quality.

By 1990-91, the gross fiscal deficit had grown to about 10% of GDP. If one includes the losses of nonfinancial public-sector enterprises, the consolidated public-sector deficit stood at around 10.9% of GDP in 1990-91, of which nearly 4.3% of GDP was for interest payments on domestic and external debt (World Bank 2000). An analysis of William Buiter and Urgit Patel (1992 : 171-205) showed that unless corrective steps were taken, India would face fiscal insolvency.

A solution to the problems is sought in policies of liberalization of trade and industrial production combined with reforms in the pattern of resource mobilization and reductions in public expenditure (Ahluwalia 1985, 1991; Joshi and Little 1994). Trade liberalization is expected to reduce the costs of production of currently overpriced domestic goods by forcing domestic producers into competition with world prices and by allowing the import of the latest (more efficient) technology. A removal of a variety of controls and licensing regulations would increase competition in the economy while at the same time allowing large-scale production where economies of scale exist. A concomitant policy of reduction of indirect taxes would lower costs to the consumer which would widen demand substantially, both at home and abroad, allowing producers to reap economies of scale. The strategy would centre around the production of industrial consumer goods, and of consumer durables in particular, as the major source of growth. The importance of domestic demand in this strategy to a large extent lies in its capacity to stimulate the production of luxury goods to be tested out at home and subsequently exported. A simultaneous reduction in the scale of public intervention on the expenditure side would release resources for the private sector, where there are incentives to produce at lower cost. Finally, the expansion in high powered money and hence the increment in the money stock should be controlled as a means to control inflation. This strategy, aiming at raising efficiency through trade liberalization, would be highly import-intensive at least initially. The inevitable increase in imports could however be phased over by accepting temporary external assistance. Balance of payments equilibrium will be restored after some time when world demand reacts to the fall in prices of Indian

exports. The above are the logics for which economic reforms were launched on the Indian economy.

The rising fiscal deficits, together with the steep rise in oil prices during the Gulf crises of 1990, put pressure on prices and the exchange rate, fuelling expectations of imminent devaluation of currency. Political instability in 1990, as reflected in two changes of prime minister within a year, led to a lack of confidence among non-resident Indians (NRIs) in the government's ability to manage the economy. The expectation of a devaluation of the rupee and the decline in confidence level led to the withdrawal of deposits in Indian banks by NRIs, and to the withdrawal of capital by other external investors. Foreign exchange reserves dwindled to a level that was worth of two weeks of imports. The specter of default on short-term external loans loomed and led to a downgrading of India's credit rating. The severe macroeconomic and BoP crisis called for immediate policy actions. Nay, the Indian policy makers realized that systemic and deep reforms were needed, and in particular that India had to abandon its insulation from the world economy if its own economy was ever to grow rapidly enough to catch up with China's. Thus, reforms of 1991 were born.

In short, the basic rationale for economic liberalization is to correct the imbalances in the economy as a result of the command economy in a mixed economic framework. The natural backlash to excessive control and in-built inefficiency has to revert to a more market-friendly policy framework where the role of government would be of strategic interventions.

## 1.4 Political Economy Aspects of Reforms

The economic reforms in India are discussed differently in different circles. While the FUND-BANK establishment designates the package as a combination of measures aimed at bringing about macroeconomic stabilization and structural adjustment, and economists, especially critical economists call it the economics of neo-liberalism, in popular perception, it boils down to a three-pronged strategy of liberalization, privatization and globalization (LPG). In official parlance, it is plain economic reforms.

It will not be out of place if we begin with a brief recollection of the political economy backdrop against which the package of reforms was launched in 1991. While we use 1991 as the official-cut-off year, the direction was set forth from much earlier on, dating back to certain measures of liberalization announced by Indira

Gandhi government in 1973, ( but without admitting that the old policies were no longer suitable), then the first IMF loan of US $5.8 billion India negotiated in 1981, which gave new impetus to economic reforms and Rajiv Gandhi's drive for economic liberalization through the latter half of the 1980s. In 1985, Prime Minister Rajiv Gandhi began to promote market-oriented reforms. New items were made available for import, and import tariff were lowered on the grounds that higher technology would be India's vehicle to rapid growth into the 21st century. While Rajiv Gandhi's efforts at economic adjustment were not the first one, he is regarded as the chief proponent of economic reform among India's prime ministers and the first prime minister to openly espouse liberalization, at least at the beginning of his period in office because he articulated the position that the development strategy of Jawaharlal. Nehru, his grandfather, had outlived its usefulness and that government-business alliances should be formed. To him, socialism and the public sector were no longer sacred cows. Rajiv Gandhi was assassinated in retaliation for the Indian intervention in northern Sri Lanka. P. V. Narasimha Rao took control of the Congress Party and the new Congress government. The new Congress government found itself in an unsustainable fiscal deficit (at 8% of GDP for 1990-91 and precarious balance of payments situation when it took office in June 1991.

In July 1991, just a month after assuming power, and with India facing an acute balance-of-payments crisis, the government of Prime Minister P. V. Narasimha Rao announced a major reorientation of economic policy because fiscal deficits were high, Inflation had reached double digits, the BoP situation serious. Forex reserves had dwindled to an amount sufficient for two weeks of imports, threatening India's first foreign loan default. Rao's finance minister, Dr. Manmohan Singh, announced in July 1991 in the Lok Sabha, the lower house of parliament, the removal of most industrial licensing requirements. The new industrial policy reduced the number of industrial sectors reserved for public sector investments from 17 to 8. Foreign investment of up to 51% of equity was granted in 34 sectors, as was automatic approval of foreign technology agreements. Besides, Singh quickly began lowering trade barriers, scaling back industrial regulation, and inviting in foreign investors. The government declared two major devaluations in early July, 1991, amounting to more than 20%. In October 1991, the Government signed an agreement with the IMF for a standby loan of US$ 2.1 billion. In sum, the government's actions -- licensing over a vast expanse of industry and dismantlement of controls, lowering and rationalizing of tariffs, and throwing the doors open to foreign investment---constituted a historic retreat from the Nehru model. And the year 1991 marked a

watershed with a sharp break in policy from inward orientation to outward orientation and from state to the market.

S.D Tendulkar and T.A. Bhavani (2012) characterize Indian reforms as systemic, continuing, and wide-ranging though the reform process had not been smooth, internally synchronized, complete, or fully successful. They cite the oft-quoted argument by political scientists (e.g. Roy Jenkins) that India is an unlikely candidate for systemic reforms because of its being a low-income democracy with large diversity in religion, language and other socio-economic-political dimensions (ethnicity, caste, regional origin) inhibiting consensus building in favour of systemic change. Moreover, India's institutional environment with its entrenched belief in economic nationalism and socialism and a governance structure of coalition politics is widely believed to be inimical to any reform. Importantly the originators of reforms constituted minorities within their own parties, with no strong political bases of their own. It is interesting to note that such political leaders not only initiated reforms in a hostile political context but also managed the reforms to move in the same consistent direction over a decade and a half.

In response to criticism inside parliament and out, the government described the adjustment measures and the IMF loan decision as the unavoidable response to a serious fiscal crisis.

The gradual process of policy change came to be known generically as "liberalization" or "economic reform," and it was sustained until the Congress party coalition lost power in 1996. Succeeding governments—of the left and right—have continued to steer India's economic policy toward a greater reliance on markets and increased exposure to the world economy.

For a few years during the mid-1990s, the Indian economy grew at the extraordinary—for India—annual rate of 7.5 per cent.

**The Politics of Initiation**

The theoretical backdrop to the politics of economic reform was a widely held set of assumptions concerning the change-resistant qualities of Indian democracy. Powerful interest groups were thought to exercise a collective veto over any attempt to restructure the policy regime. Pranab Bardhan's model of the "dominant proprietary classes"—widely quoted during the late 1980s and early 1990s—was the classic statement of this view.

Much of the debate during and since 1991 focused on the role of the international financial institutions (IFIs), namely the World Bank and the International Monetary Fund (IMF), in provoking India to introduce a new, more radical wave of market-oriented reforms than had been contemplated during the 1980s. There were conditions—or "policy conditionalities"—attached to some of the loans that the Indian government received from the World Bank and the IMF at the height of the foreign-exchange crisis. Critics of the new wave of reforms argued that India was suffering only a short-term balance-of-payments crisis, not a fundamental economic catastrophe. Only IFI pressure, said the critics, could explain why a short-term crisis was met with such far-reaching policy reversals. In this vein, Montek Singh Ahluwalia, the chief official at the finance ministry during the early 1990s, subsequently argued that India's reform effort was "homegrown," Rob Jenkins argued that the reorientation of India's development strategy could be characterized, to a considerable degree, as "reforming by stealth"—a process in which various tactical maneuvers were employed by governing elites.

On the other sides of coin, there were other political aspects of the economic reforms that loomed large on the political sky of the Indian economy.

The fact of the matter was that even in the heydays of Nehru, India never really followed the path of welfare state. The Five Year Plans and the entire policy package followed in the 1950s and 1960s had very little welfare thrust or content and the whole emphasis was on strengthening India's corporate sector. All the big monopoly houses grew and flourished in the shadow of the public sector and Five Year Plans.

This pattern of economic development facilitated the rise and consolidation of India's capitalist class along with a rich upper middle class and upwardly mobile section of the middle class. Interlinked with this was the growth of the kulak lobby, alongside of course the old landlord class.

This was the domestic social base behind the current spate of economic reforms in India. Having attained considerable strength under the so-called license-permit-quota Raj, these forces clamored for greater operational freedom and close integration with the world economy. The regional economic elites and corporate houses with a high degree of regional concentration tried to utilize the state governments to strike direct deals with the global capital. Economic elites welcomed Fund-Bank conditionality. Thus economic reforms came into its operation.

## 1.5 Typology of reforms

Here we shall discuss the typology of reforms or contents of the reform programmes in India. The main problem in 1991 being to prevent a collapse of the balance of payments and to curb inflationary expectations, the programme of structural reform was preceded by a programme of macroeconomic stabilization. The immediate stabilization measures were a 19 per cent devaluation of the Rupee and a rise in interest rates designed to restore confidence and to reverse short-term capital outflow. As part of a policy to contain the growth of aggregate demand in order to reduce inflationary pressures and relieve the balance of payments a number of measures were introduced in 1991/92 to control credit (including an increase in interest rates) and to reduce the fiscal deficit. Subsequently, attention focused on fiscal reform, industrial policy, and further trade and financial sector reforms and public sector reforms:

### 1.5.1 Fiscal Reforms

In 1990, in-pre reform India, the structure of taxation was very unbalanced. Some 80% of total revenues came from customs and excise taxation and less than 10% of revenue from personal and corporate income tax. Customs and excise duties were extremely complex, with numerous rates, active political lobbying about each tariff line, and enforcement difficulties. Only 6 million individuals paid income tax. The high-level (government) Chelliah Committee in the early 1990s accepted the tenets of neo-liberal policies and set out a strategy to reduce marginal rates of taxation, widen the tax–base by removing exemptions, and simplifying laws, administration and procedures.

The heavy reliance on indirect tax rates characterizing the pre-reform tax structure was found to lead to higher domestic price levels and a reduction in the international competitiveness of domestic industries. The major source of indirect tax revenues being customs duties, the pre-reform tax structure served to protect domestic industry from foreign competition, which led to inefficiencies in production and investment at home. Consequently, tax system reform has been an important element of the new economic policies launched in the early 1990s as part of an IMF-financed structural adjustment programme. The need to correct fiscal imbalances and the transition from a centralized plan to a market economy are the important local factors hastening tax reforms. Difficulties in compressing expenditures necessitated

that tax system reforms take an important role in fiscal adjustment strategy. The transition from plan to markets required the substitution of administered prices with market-determined prices, replacement of physical controls with financial controls, and the substitution of public enterprises profits with tax revenues. Similarly, tax reforms become imperative in a globalizing environment. Indirect tax rates were slashed, in particular customs duties, which were reduced in phases to a peak rate of 110% in 1992, 85% in 1993, 65% in 1994 and to 50% in 1995 (with a few exceptions). Import duties on capital goods were reduced from 85% prior to the reforms to 25% in 1995.

The structure of excise taxes was simplified and a number of rates were lowered (*Economic Survey* 1995-96).

**Direct tax reforms** undertaken after 1989/90 were geared towards a tax structure relying on more moderate tax rates but a larger base — in an effort to raise tax compliance. Prior to the reforms, high direct tax rates had not yielded correspondingly high tax revenues. The maximum marginal rate of personal income tax, notably since 1985/86, was reduced from 58 to 40 %.

Tax reforms initiated after 1991-1992 attempted to simplify tax rates considerably. The number of brackets was reduced to three for personal income tax. In 1992-93, the prescribed rates were 20%, 30%, and 40%, respectively. Financial assets were excluded from the wealth tax, and the maximum marginal rate was reduced to 1%. Further, simplification was achieved in 1997-1998 when the three bracket rates were reduced to 10-20%. The budget for 2005-2006 made some major changes in structure by raising the exemption limit to Rs. 1000,000, and abolishing the provision for a standard deduction. The exemption limit for women and senior citizens were higher, respectively, at Rs.135,000 and Rs. 185,000.

In the case of Corporate taxation too, the basic rate was brought down to 50%. The 2005-2006 budget finally reduced the corporate income tax rate to 30%. In 1997-1998 personal income tax rate was reduced and the company rate was brought down to 35%.

The most important reform is in tax administration. Expansion of tax deduction at source (TDS) is one of the significant measures.

**Reform of Indirect Taxes**

Further reform measures on excise duties included gradual unification of rates.

In 1999-2000, almost 11 tax rates were merged into 3. In 2000-2001, Central VAT (Cen VAT) was introduced.

Important features of tax reform also include reduction of custom duties to bring them in line with other developing countries, and shifting the bulk of taxes to an ad valorem basis. The ad valorem tax replaces the specific excise duties on many domestic manufactured goods that were charged at varying rates on different goods. The long–term objective is to move to a unified value-added tax. Further, simplification and rationalization of domestic indirect taxes are being considered. The tax reforms taken together are intended to avoid microeconomic distortions and to attain macroeconomic buoyancy of tax revenues.

In sum, tax reforms thus far have involved reductions in income and corporate tax rates, rationalization of customs and excise duties, and elimination of several tax exemptions. The maximum marginal rate of income tax, at 30% is moderated by international standards. Still, India's tax –GDP ratio is low by international standards.

**Effects of the Fiscal Reforms**

Following the tax system reforms, there has been an increase in the revenue productivity of the personal income tax. The performance of the tax system has shown improvement. And that tax compliance has indeed improved after a reduction of marginal tax rates. G.S Bhalla concludes that the 1996-1997 tax cut was a huge success in increasing revenues. The increase in the scope of TDS is the main contributor to the revenue increase. The proportion of TDS to total revenue collections increased from 22% in 1994-95 to 50% in 1996-1997 and further to 67% in 2001-2002.

Between 1997 and 2000 the number of individuals filing tax returns increased by 120%. In 2003-2004, as many as 29 million people paid income tax as compared to 3.9 million in 1989-1990. The tax –GDP ratio has doubled to more than 2% of GDP. That is to say, that there has been an expansion in coverage, which in turn means that a larger proportion of population comes into the tax net, thereby it making an improvement in horizontal equity.

## 1.5.2 Trade Policy Reforms

India substantially liberalized its external sector over the 1900s in accordance with policies derived from neo-liberal economic theory that emphasizes that trade liberalization is good for growth

1. As of December 1995, more than 3,000 tariff lines covering raw materials, intermediaries and capital goods were freed from import licensing requirements;
2. Quantitative restrictions (QRs) on imports of manufactured consumer goods and agricultural products were finally removed on April 1, 2001, almost exactly ten years after the reforms began, and that in part because of a ruling by a World Trade Organization dispute panel on a complaint brought by the United States;
3. The peak tariff rate was reduced from 300% at the beginning of the 1990s to 40% by the end;
4. In the above same period the weighted tariff average fell from 75% to 25%;
5. Tariff rates, which were among the highest in the world, fell across the board, on intermediate, capital and consumer goods, and the tariff reductions are being complemented by significant tax reform.
6. The complex customs tariff structure in 1991 has been greatly simplified. In 2001-02, custom duties included four rates (35%, 25%,15% and 5%).

In addition to those, the immediate actions to counter the balance of payments crisis in 1991 were an almost 20 per cent devaluation of the Rupee to make exports competitive and imports more expensive, and the exchange rate has floated to a determined rate. Except for some services, such as purchase of insurance abroad, travel , and imports of some consumer goods, all current account transactions are permitted without government approval.

The overall outcome was a distinct increase in the degree of integration of India with the world economy. The share of trade ( imports plus imports) in GDP or trade orientation ratio increased from 13% to 20% over the 1990s.

Besides, the SEZ Policy was introduced for the first time in India April 2000 following China which had established four SEZs in 1980 as a part of its dual track liberalization, in India, as a part of the Export-Import (EXIM) policy of India.

Subsequently, the major measures of trade reform were reductions in import tariffs from July 1991 onwards, a gradual elimination of import quantity restrictions starting in February 1992, and establishment of full convertibility of the Rupee on the current account, permitting release of foreign exchange beyond the earlier indicative limits without prior approval of the RBI (Economic Survey 1995-96). In

March 1993, India moved from the earlier dual exchange rate system to a single, market determined exchange rate system. Under this new system, the exchange rate of the Rupee is determined by demand and supply in the foreign exchange market, and there is no officially fixed exchange rate of the rupee. The Reserve Bank however stands ready to intervene if considered necessary, such as happened for instance in 1993 and 1994, when large inflows of foreign portfolio investments threatened the stability of the Rupee against the US dollar, and a sharp appreciation of the Rupee was avoided through large purchases of dollars by the Reserve Bank (*Economic Survey* 1995-96). After already having depreciated by 49.8 per cent against a weighted average of the currencies of its ten major trading partners between 1984/85 and 1990/91, the rupee depreciated by a further 47.8 percent between 1990/91 and 1994/95.

**Effects of Trade Liberalization**

The economic reforms initiated in July1991 brought about fundamental changes in the functioning of the foreign trade sector. The change in the trade, industrial and foreign investment policies combined in the reform of the exchange rate system eased the BoP constraint on the economy. The two-step devaluation in July 1991, the move to a dual exchange rate system in March 1992, the unification of exchange rate in March 1993 and the steps towards current account convertibility in 1994 and completed in August 1994 all brought about an appropriate pricing of foreign exchange while the trade policy reforms reversed the earlier policy which had a bias against exports. In response to these changes, both import and export trade grew rapidly in India in the 1990s. Since then as part of its commitments as a member of the WTO India had removed remaining quota barriers to trade, set maximum bound tariff rates and lowered overall protection. It is now a much more open economy than in the previous decades (for example, total foreign trade was 45% of GDP in 2007 as compared with only 16 % in 1990), although its average level of protection is still relatively high by current standards of WTO members.

### 1.5.3 Industrial Policy Reforms

The New Industrial Policy, announced in July, 1991, was in line with the liberalisation measures announced in the eighties. Major deregulation measures announced in this policy are as follows.

1. **Industrial Licensing Policy**

Trade liberalization called for industrial policy reforms. The area of industrial

policy reform has witnessed the most drastic change by means of the virtual dismantling of the system of industrial licensing that had characterized earlier policy. Licensing requirements for entry of new firms and for growth of the existing firms have been abolished, except for a few strategic and hazardous industries and some industries reserved for the small-scale sector. The law regulating monopolies has been greatly amended to facilitate the growth of firms through mergers and acquisitions.

**2. Policy on Public Sector**

The 1991 industrial policy reduced the number of reserved industries for public sector production from 17 (as mentioned in the 1956 Resolution) to 8. The industries reserved for the public sector included: (i) arms and ammunition; (ii) atomic energy; (iii) coal and lignite; (iv) mineral oils; (v) mining of iron/ manganese/chrome ores; (vi) mining of copper/lead/zinc/tin; (vi) mining of gypsum/sulphur/gold/diamond; (vii) mining of copper, lead, zinc, tin, molybdenum and minerals specified in the schedule to the atomic energy order of 1953 and (viii) rail transport. But later, five more of these reserved industries under public sector were also dereserved. At present, there are only three industries left reserved exclusively for the public sector.

The policy also suggested that those public enterprises which are chronically sick and which are unlikely to be turned around will, for the formation of revival/ rehabilitation schemes, be referred to the Board for Industrial and Financial Reconstruction (BIFR) in order to protect the interests of workers.

**3. Monopolistic and Restrictive Trade Practice Limit**

Under the Monopolistic and Restrictive Trade Practice Act, all firms with assets above a certain size (Rs.100 crore since 1985) were classified as MRTP firms. Such firms were permitted only for selected industries and that too on a case-to-case approval basis and a reconsideration of labour legislation is made along with the creation of a social safety net to facilitate reorganization and closing down of sick industries. The New Industrial Policy removed the threshold limit in assets in respect of MRTP companies eliminating the requirements of prior approval. In the amended MRTP Act, emphasis has shifted to taking appropriate action against with monopolies now identified as those who control over 25 percent share of the market. The New Industrial Policy has therefore widened and strengthened the provisions of the MRTP Act.

4. **Policy on Foreign Investment and Technology Agreements**

   In case of foreign technology agreements and foreign investment, earlier it was necessary to obtain specific approval for each project. This resulted in delays and government interference hampering business decision making. The New Industrial Policy allows automatic approval for foreign direct investment up to 51 percent foreign equity. The industries in which such automatic approval was granted included a wide range of industrial activities (e.g. capital goods, metallurgical, entertainment & electronic, food processing, etc.) having significant export potential. 100 percent foreign direct investment is allowed in: (i) Special Economic Zones (SEZs) for all manufacturing activities; (ii) investment in the power sector; (iii) oil refining; (iv) telecom sector for some activities; (v) off shore Venture Capital Funds/Companies investing in domestic venture capital undertakings; etc. Besides, the 1993 amendment to FERA eliminated the differential treatment of FERA companies..

5. **Removal of Mandatory Convertible Clause**

   Since large part of industrial investment in India is financed by loans from banks and financial institutions, these institutions included a mandatory convertibility clause. The clause provided for the option of converting part of their loans into equity. This clause was interpreted as unwarranted by private firms who feared that it could lead to their undertakings taken over by the financial institutions. The new industrial policy provided for financial institutions not to impose the convertible clause.

The New Industrial Policy of 1991 thus proposed liberalizing, globalizing and privatising the industrial sector. Towards this end, three sets of reforms were introduced. These were: ONE, deregulation, de-licensing, decontrol and de-bureaucratisation of industrial licensing system; TWO, liberalization of foreign trade and currency transactions; and THREE, initiation of several measures to facilitate foreign direct investment inflows. All these measures were launched in 1991 and since then, continued liberalization measures have been introduced every year in each new budget. (For Details, Read Indian Economy M.A. Economics-Paper 3 of the Study Material).

However, of late, in the field of administrative reform process, to reduce the compliance burden of the BPO ( business process Outsourcing) industry, government announced new guidelines on OSPs (Other Service Providers) on 5th November

2020, for example. Under the new regulations, the registration requirement for OSPs has been done away with altogether and the BPO industry engaged in data-related work has been taken out of the ambit of OSP regulations.

**Effects of the Industrial Policy Reforms**

Due to the balance of payments crisis in the 1990s, output dipped in 1991-92, but boomed for four years after that, peaking in 1995-96. For example, after the economic crisis of 1991 when manufacturing declined by about 2.5% in that year, it rebounded strongly for the next three years with annual growth peaking at 16% in 1995., However growth decelerated in the next few years only staring to improve consistently after 2001.This was followed by a steep deceleration for seven years until 2002-03. A second boom took place for another four years from 2003-04 to 2007-08. During the 19 years since 1991-92 (i.e. 1992-2010), consumer durables grew the fastest at 9.3 percent per year followed by capital goods at 8.1 percent per year. The Indian economy experienced a high growth in the service sector in the post reform period, the share of which rose from 44 percent of GDP in 1991-92 to 57 percent in 2009-10. During the same period, the share of the agricultural sector declined from 33 percent to 17 percent and that of the industrial sector increased modestly from 23 percent in 1991-92 to 26 percent in 2009-10.

What has happened to industrial growth since the reforms? Industrial growth which was very low in 1991-92 (less than 1 percent) started picking up from 1993-94 reaching a high of 13 percent in 1995-96 but then again declined to around 5.5 percent in 1999-2000. Not withstanding these intermittent ups and downs, the overall growth of Indian industries over the 10-year period of 1995-2005 and the subsequent 7-year period of 2005-13 has been an uniform 6.8 % growth average annual. The annual growth rate of manufacturing sector, measured by index of industrial production(IIP), during the six years since the reforms was low. Besides, during the 1990s, despite far-reaching reforms and faster growth of manufacturing output,total factor growth declined across a vast majority of industries.

Among the factors identified as responsible for this 'less than the desired growth' are :

- Industrial growth did not take place as expected since the growth in the labour intensive industries did not increase and hence industrial employment and output remained the same.
- Due to lack of adequate infrastructure, export credit and unsuitable

macroeconomic policy environment, India's exports were restricted to skill and technology-intensive products, although it possessed competitiveness to produce and export a large number of other products.

- Some of the other factors responsible for the decline in the industrial growth rate are : (i) decline in the growth of exports in 1997; (ii) tight money policy followed in 1995-96; and (iii) overestimation of growth in demand.

Thus, the Indian manufacturing sector did not perform well as some other emerging economies mainly due to certain structural distortions. These distortions are: (i) problems with reallocation of labour across sectors; (ii) excessively small scale firms; (iii) low firm turnover, (iv) poor market orientation; (v) persistent state ownership; etc.

**Recent phenomenon : Industrial growth in 2010s**

The Indian economy encountered a "once in a century" crisis due to the COVID-19 pandemic that affected economic activities and consequently impacted the livelihood of billions of people. The industrial sector, not an exception to this shock, experienced a sharp decline during the period of the lockdown. The economic activity, however, started recovering as the unlocking process began. The various subcomponents of Index of Industrial Production (IIP) and eight-core index have experienced a V-shaped recovery with consistent movement being seen towards the pre-crisis levels. The broad-based quick revival of the industrial activity stemmed from remedial measures, reforms, and the sizable stimulus package announced by the Government of India (GoI) under the Atmanirbhar Bharat package. Based on the IIP, the industrial activity contracted by 1.9 per cent in November-2020 recovering from the nadir of (–) 57.3 per cent in April-2020.

In fact, our industrial performance is quite poor by international standards. The growth of production is low and technological performance is tardy. The missed opportunities in international trade in manufacture have not generated employment. The growth of real wages of industrial labour in India is also low, as compared to other countries.There is no doubt that if India had maintained its share of world trade at the same level as in 1950(i.e.2%), both the income and employment situation would have been much better than they were four decades later.

## 1.5.4 Financial Sector Reforms

The severe BoP crisis in 1990-91 proved to be the trigger for economic reforms in several sectors, including the financial sector. The reform initiatives in the

financial sector started with the government appointing : Narasimham Committee to have a domestic financial sector reforms. After 1992, the reform programme in the financial sector largely followed the broad approach set out by this committee, supplanted by the Second Narasimham Committee, which was set up in 1997.

Reforms in the financial sector has been aimed at strengthening banks and at deregulating capital markets. Indian banking system was dominated by several large public sector banks and characterized by heavy mandatory reserve requirements designed to support government borrowing at low administered interest rates. Interest rates were almost entirely administered before 1991. Interest rate revisions were introduced both as part of a policy of financial sector reform under the structural adjustment programme and as an anti-inflationary measure under the stabilization programme (*Economic Survey* 1991-92). As another part of a policy to fight inflation, attempts were made to delink government budget deficits from net central bank credit to the government so that central bank claims on the government could become an independent instrument for monetary policy (*Economic Survey* 1993-94).

1. In line with the recommendations of the Narasimham Committee Report on Financial Sector Reforms, both the SLR (the minimum percentage of deposits that banks must hold in government securities) and CRR (the minimum proportion of deposits that banks must hold in cash) have been reduced.

   It was decided to reduce the SLR in stages over a three-year period from 38.5 per cent to 25 per cent, as part of a policy to reduce the level of preemption of resources by the government, and to reduce the CRR over a four-year period to a level below 10 per cent (Economic Survey 1992-93). The cash reserve ratio was initially brought down from its legal maximum of 15 per cent, as stipulated in July 1989, to 14.5 per cent in April 1993 and further to 14.0 per cent in May 1993. In 1992/93, the incremental SLR was reduced from 38.5 to 30 percent (Economic Survey 1992-93) and by October 1993, the incremental SLR was fixed at 25 per cent (Economic Survey 1993-94). By September 1995, the average effective SLR had come down to 28.7 per cent (Economic Survey 1995-96). The objective was to increase the availability of funds to the banks for lending.

2. The complex structure of differential interest rates charged and paid by commercial banks has been simplified and rationalized to make them more profitable.

3. Regulated interest rates have been replaced by maximum deposit rates and minimum lending rates.
4. Interest rates on long-term government securities have also been raised close to market levels to reduce the burden on the commercial banks.
5. Accounting practices and macro prudential norms are now conform to the international standards of the Basle Accord. India adopted international prudential regulation and supervision and practices regarding capital adequacy, income recognition, provisioning requirement and supervision. These formed a critical component of the financial sector reform programme. These norms were progressively tightened over the years, particularly against the backdrop of Asian Financial crisis, that occurred in 1997. The required capital adequacy ratio was increased to 8% in the banking sector. As a further prudential measure against credit and market risks, risk weights were made universally applicable to government securities and non-government securities, to provide a buffer against price fluctuations. Besides, a rating system for Indian banks was also introduced. In area of supervision, a full-fledged institutional was developed to get a strong and stable financial system.
6. New private sector banks are being licensed to inject competition into the banking sector.
7. To improve performance and accountability in public sector banks, government ownership is being diluted (subject to a minimum government share of 51%) in banks that raise fresh capital by inducting new private shareholders.

As a result of these and other measures, some progress was noticeable in the performance of the Indian banking sector. Apart from the banking system reforms, financial sector reform also encompasses the reform of capital markets aimed at financing investment in the private sector and at attracting foreign portfolio capital. Foreign institutional investors, such as mutual and pension funds, are now allowed to invest in the capital market.

A second route for foreign portfolio investment has been the issue of shares abroad by Indian Companies, and several Indian corporations have mobilized significant amounts of capital in this way.

Interest rates in the domestic capital market have been deregulated, and the need for prior government approval of the size and price of equity issues in the primary capital market has been dispensed with. The deregulated capital market is to be

overseen by the SEBI (Securities and Exchange Board of India), an independent statutory regulatory body that introduced a framework of rules and regulations to govern trading practices, standards of disclosure, speed of settlement, and transparency of transactions. This appears to have helped the market recover from a major securities scandal in which banks funds were siphoned off into the stock market. A new National Stock Exchange with computerized screen trading has commenced operation, and other stock exchanges are being computerized and modernized.

**Effects of Financial Sector Reforms**

Following reforms in the financial sector, significant progress was made in the 1990s. There was a steady decline in the level of resource pre-emption from the banking system Both the CRR and SLR were reduced from their high levels of 15% and 38.5%, respectively, to 9% and 5% in 1991-92.

Interest rates in various segments of financial markets were deregulated. This preceded the abolition of controls on capital issues and freeing of interests on private bonds and debentures.

Predential regulation & supervision has improved. The financial liberation on process has also enabled to reduce the overhang of non-performing assets ($NPA_S$). There has been a general imporvement in other financial indication cors like better return on assets.

The RBI's regulatory and supervisory responsibility was widened to include the financial institutions and non–banking financial companies.

The consolidation of the financial system during the second half of the 1990s increased the resilience of the Indian economy to external crisis.

In the sphere of external financial policy, there was a progressive liberalization of foreign direct and portfolio investment, and approval procedures were considerably simplified. As a result, restrictions on inflow of capital into the economy were significantly

To sum up, there was considerable progress in the broadening and strengthening of the India's financial system in the last decade of the 20$^{th}$ century.

## 1.5.5 Public Sector Reforms

Unlike other countries undergoing similar reforms, India has not undertaken a massive privatization of public sector enterprises. Government ownership is being diluted through the sale of government equity as well as through fresh issue of capital to the public. The induction of private shareholders and the trading of stock

in the stock markets are intended to make these enterprises more profitable and increase managerial accountability. Budgetary support to loss-making public sector enterprises is being phased out and areas formerly reserved for the public sector, such as civil aviation, petroleum exploration and refining, and parts of telecommunication, have been opened for the private sector to compete with the public sector. An exit policy, allowing the closure and restructuring of unviable firms, is being put into place and a World Bank-assisted National Renewal Fund, to provide compensation for displaced public sector workers, has been established.

**Public sector performance after reforms**

As part of the stabilization effort, public investment and expenditure ratios are expected to fall; they did so in India. However, interestingly, public sector output growth and surplus generation improved in the 1990s. The public sector's share in GDP rose from 1.3% to 24.8 during 1992-95. Share of public sector in manufacturing rose. In institutional terms, much of the growth occurred in non-departmental enterprises.

Along with output growth, public sector's internal resource generation ratio also improved. A sharp rise in profitability (gross profit as percentage of capital employed) of central government public-sector enterprises (PSEs)—even excluding petroleum – is also evident.

At least so far, in the aggregate, public sector has clearly withstood the 1991 policy shock and continues to improve its performance.

The public sector enterprises policy enunciated by the Government in November 2020 spells a complete change in paradigm as compared to its policy of import substitution and self-sufficiency which became the basis of Mahalanobis Plan in 1956. However, the inherent inefficiencies leading to low productivity in the PSEs, high-cost structure and strained finances led the GoI to privatize the PSU after 1991. Thus began the journey of privatization/disinvestment in the country.

## 1.5.6 Results of reforms in Some Select Sectors

The measures introduced by the government by liberalizing import -export trade, domestic investment policies and capital flows from abroad, etc., were wide-ranging and led to increased competition in areas earlier dominated by monolithic pub-lic sector enterprises.

The Indian economy had undergone an extraordinary transformation since the reforms in 1991. In years 2007-06, India's rate of growth accelerated to 9.2%.

Services sector growth are impressive. The manufacturing sector has broken out of stagnation to grow at an average of 11.6 % in 2006-07. Foreign exchange reserves exceeded $177 billion on 12 January 2007. India's external debt is lower among the top 15 debtor countries.

Following the reforms, the central government's fiscal deficit was sharply reduced, from 6.6% of GDP in the crisis year of 1990-91 to 4.7 % in 1992-93 and 4.8% the year after. However, the deficit rose to 5.8% in 2000-2001. Further, the fiscal deficits of states have risen substantially from about 3% of GDP in 1990-1 to 4.6% in 1999-2000 and 4.2% in 2000-2. In all, the deficit of the centre, states, and nonfinancial public-sector enterprises rose to 11.7% of GDP, exceeding its level of 10.9 % in the crisis year of 1990-1. India's general government deficit was among the highest in the world, and the government debt (domestic and external) is very high. Thus, the tusk of fiscal consolidation is yet to be completed.

By 1996—7, import –weighted average tariffs on all imports had come down to 25%, from 85% in 1990-91. Since then, they have been rising slowly. QRs on some imports were removed beginning in 1996-7. Those remaining, mainly on consumer goods and agricultural products, were removed on 31March 2000 and 1 April 2001.

Some important changes in export –import policies have helped to reduce the anti-export bias in India's international trade. The effective exchange rates for exports were closer to that for imports. In 1993-94 and 1994-95, exports increased by nearly 20% per annum, financed 90% of imports (compared to 60 % in the latter half of the 1980s). Domestic industry experienced a broad-based recovery with industrial growth of more than 10% in 1995-96 (as against 0.5% in 1991) The capital goods sector, despite import liberalization, grew by nearly 25% in 1994. This experience was contrary to the popular belief that openness in trade is injurious to the health of domestic industry. It would not be out of place here to say that India's trade policy in the future must be to recapture the lost ground in India's share in world trade, as it was 2% in 1950. A feasible goal during the mid-1990s was to raise the India's share of trade to at least 1.5% in the next 10 years. This would require that India's exports and imports should increase substantially at a faster rate than the growth of the GDP or that of international trade in general. Both exports and imports had to grow in a balanced manner so that there is no recurrence of a BoP problem or a substantial addition to commercial debt.

Integrating its domestic economies with the world economy was an important objective of reforms. Several indicators of integration are available, such as share of

trade in GDP, growth of exports, trends in capital inflows. All the indicators showed a positive sign. The so-called information technology revolution of the 1990s opened up hitherto unavailable opportunities for export of services. India experienced a significant increase in the average annual growth rate of value of its merchandise exports of goods and services in the 1990s. A major contributor to India's exports of goods and services is the software sector. Receipts from software grew at an annual rate exceeding 50% in the five years ending in 1999-2000.

Following the reforms, our foreign exchange position was also stabilized, which further increased the growth potential of the economy and reduced poverty levels.

Turning to FDI, the Indian reforms of 1991 affected FDI to a limited extent. As a consequence of limited liberalization, FDI increased from $77 million in 1992 to $3.6 billion in 1997. Portfolio investment is volatile. It fell from $4.7 billion in 1994 to $4.6 billion in 1996.

These are the performances of the Indian economy after economic reforms. We have not counted here the performances of the social sector performance.

## 1.6 Conclusion

This module briefly notes the analytical underpinnings of pursuing economic reform programmes in our country towards globalization and liberalization from a long–run perspective.

This module considers the political economy configurations associated with changing economic policies in the Indian economy, especially "liberalisation". While real national income has grown at a faster rate since the 1980s compared to the earlier decades, there has been less structural change than might have been expected. Some features of economic backwardness persist, such as substantial poverty, a high dependence upon agriculture as the largest employer, and continuing underemployment in the economy.

The neoliberal economic reforms of the 1990s were based on the notion that greater freedom given to private agents and market functioning would ensure more efficient and more dynamic outcomes. The government's aim was also to restructure production towards areas of international "comparative advantage". By the early years of the current century, therefore, the Indian economy had undergone the following policy changes : very substantial reduction in direct state control in terms

of administered prices and regulation of economic activity; privatization of state assets; reduction of tax rates; cutback of public productive investment as well as certain types of social expenditure; trade liberalisation; financial liberalization; liberalization of current account transactions; and a significant degree of capital account liberalization.

## 1.7 Summary

This module considers the political economy configurations associated with changing economic reforms and policies in the Indian economy.

The neoliberal economic reforms of the 1990s were based on the notion that greater freedom given to private agents and market functioning would ensure more efficient and more dynamic outcomes. The government's aim was also to restructure production towards areas of international "comparative advantage". By the early years of the current century, therefore, the Indian economy had undergone the following policy changes: very substantial reduction in direct state control in terms of administered prices and regulation of economic activity; privatisation of state assets; reduction of tax rates; cutback of public productive investment as well as certain types of social expenditure; trade liberalization; financial liberalization; liberalisation of current account transactions; and a significant degree of capital account liberalization.

**Dual track liberalization :** it is a reform strategy of market liberalization in which a market track is introduced while the plan track is maintained at the same time-- that is, continuing to enforce the existing plan while simultaneously liberalizing the market. Under the plan track, economic agents are assigned rights to and obligations for a fixed quantity of goods and services at fixed planned prices as specified in the pre-existing plan. Under the market track, economic agents can participate in the market at free market prices. The essential feature of the dual track strategy to market liberalization is that prices are liberalized at the margin while infra-marginal plan prices and quotas are maintained for some time before being phased out. Although the dual track reform strategy is widely adopted in China during its transition from plan to market, it is also used in other countries.

**Export and import policy :** Beginning 1992, the government effected certain major changes in import and export policies. Exchange restrictions on current transactions and various types of quotas for import of goods, with the exception of

most consumer goods, were abolished. The items subject to export restrictions was drastically reduced. The exchange rate, after two substantial devaluation was largely determined by the market (although the RBI intervened in the market from time to time). Import duties, which were among the highest in the world, were brought down progressively. Maximum tariffs were from over 4000% in 1990-91 to 50%, with some exceptions. The average tariff weighted by volume of imports were reduced from 87% to 27%.

**Industrial policy :** An economic development strategy in which a national government identifies key domestic industry, critical to country's economic future and then formulates policies that promote the industrial competitiveness of these industries. The main purpose of industrial policy is to diversify the economy and generates new areas of comparative advantage.

**Major thrusts or contents of India's reforms of 1991 :** It addressed the macroeconomic and BoP crisis through fiscal consolidation and limited tax reforms, removal of controls on industrial investment and on imports (other than consumer goods), reduction of import tariffs, and creation of a more favourable environment for attracting foreign capital. The reforms also included an initial devaluation, and subsequent prudent management of movements in the exchange rate while allowing market forces to play a major role in its determination, making the rupee convertible for current account transactions, etc. and finally, opening the energy and telecommunications sector for private investment (both domestic and foreign.). All in all, it included a progressive reduction in the involvement of the state in the economy and a concomitant increase in that of the market under a 'mixed economy' framework. Another major goal was to integrate its economy with the world economy to a much greater extent than was the case before reforms. Finally, India became engaged in reforms of economic(e.g. financial ), political, and administrative institutions to enable those institutions to serve her market economy efficiently.

**Structural adjustment :** It is defined as "a process of market-oriented reforms in policies and institutions, with the goals of restoring a sustainable BoP, reducing inflation, and creating conditions for sustainable growth in per capita income. Structural adjustment programmes generally start with a conventional stabilization programme, intended to restore the viability of current account and the budget.

**Trade and Payments Policy reforms after 1991 :** The trade and payments policy regime prior to the initiation of economic reform was more or less complex.In order to remove the complexity, the thrust of the major reforms in trade and

payments policy reforms was basically aimed at accelerating the transition of the Indian economy towards greater integration with the world economy along the line of export promotion and international competitiveness. The first phase of trade liberalization basically aimed at removing the barriers of exports through unification and devaluation of the exchange rate and also removing the quantitative restrictions (QRs) on imports of intermediate and capital goods. In the second phase remaining QRs were gradually moderated and tariff rates were substantially reduced towards greater uniformity. Following the recommendations of the Chelliah Committee on Tax reforms, the peak tariff rate was slashed to 65 per cent in 1994-95 from 110 per cent in 1992-93 and 85 per cent in1993-94. The Central Budget of 1995-96 effected a further reduction in peak tariff rate to 50 per cent, together with reduction in almost all other rates. With a view to avoiding the cascading effects and to curb the general inflationary potentials, the custom duty on critical raw materials was substantially reduced and attempts have been made to simplify and rationalize tariff structure across sectors. The EXIM Policy of 1992-97 was modified to augment the quality and competitiveness of India's exportables.

**Trade Policy :** It consists of inward and outward movement of goods and services, which result into outflow and inflow of foreign exchange from one country to another.During present times, international trade policy is a vital part of development strategy and it can be an effective instrument of economic growth, employment generation and poverty alleviation in an economy.

There are a variety of means such as institutional innovation, organizational reform and policy initiatives which may be deployed severally, or in concert, to attain the desired long run objectives relating to foreign trade. But among trade policy, in particular, trade policy, as experience shows, whether in foreign trade or in investment, has a certain primacy. For, if policy levers are not properly wielded, wrong signals then transmits through a totally inappropriate set of incentives or disincentives,

## 1.8 Exercises

**A. Short-answer type Questions**

1. What is meant by "reforms by stealth" ?
2. What is dual track liberalization? What are its characteristics?

3. Identify the factors as responsible for 'less than the desired growth' in the industrial sector during the 1990s.
4. What are the factors that the Indian manufacturing sector did not perform well as some other emerging economies? Explain.
5. Do you agree with the statement that in 1990, in-pre reform India, the structure of taxation was very unbalanced? Give reasons for your answer.
6. What are the mechanisms through which fiscal imbalances cause internal and external disequilibria?
7. Write a short note on export and import policy.
8. What is your suggestion to increase India's share of trade in future?
9. Write a note on the trade and payments policy of India after 1991.
10. What is the essential difference between industrial policy and trade policy of a country ? What were the basic characteristics of New Industrial Policy in India ? Mention one of the major changes that has been brought about through this NEP?

**B. Medium-answer type questions**

1. Write down the five policy areas that have been substantially liberalized over the course of the 1990s.
2. State the major thrusts of India's 1991 neo-liberal economic reforms?
3. State the three sets of reforms which broadly signify the NIP of 1991.
4. Write down the various reforms in the financial sector and its impact on the Indian economy.

**C. Long-answer type Questions**

1. How were the India's economic reforms of 1991 born? Explain.
2. Elucidate in brief the salient features of reforms in industrial and trade policies in India.
3. Write down the reasons for which India was put to difficulty in 1991?
4. Critically assess the impact of economic liberalization on the Indian Economy.
5. Critically discuss the rational behind the 1991 economic reform in India.
6. How did politics play critical role in enhancing reforms of 1991 in India.

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# Unit - 2 ❑ Financial Sector Reforms In India

**Structure**

**2.1 Objectives**

**2.2 Introduction**

**2.3 Reforms in the Money Market**

**2.4 Reforms in the Capital Market**

**2.5 Progress after Reforms**

**2.5.1 Progress in Money Market**

**2.5.2 Progress in Capital Market**

**2.6 Conclusion**

**2.7 Summary**

**2.8 Exercises**

**2.9 References**

## 2.1 Objectives

After reading this unit, you will be able to:

- Have a brief overview of the financial sector reforms;
- Understand reforms in the money market;
- Also have pros and cons of reforms in the capital market; and
- know the impact of reforms both in the money market and capital market.

## 2.2 Introduction

Prior to 1991 reforms, the primary function of India's financial sector was to lend support to the government's funding needs. Banking sector was highly controlled. The other arms of financial sector—the equity markets and the foreign exchange markets-remained underdeveloped and the Indian financial sector was a classic case

of 'financial repression' characterized by extensive regulation, prevalence of administered interests rates as well as a distorted interest rate mechanism, directed credit programmes, an economically weak and unviable banking sector, which also suffered from the lack of proper accounting and risk- management systems along with a lack of operational transparency and with no strict adherence to prudential norms in banking operations, monetary policy subservient to fiscal policy, that is to say, monetary policy played an accommodating role to fiscal policy and, finally there was lack of incentive to seek efficiency. Capital markets were underdeveloped, with Indian corporate entities unable to raise capital in domestic markets due to the public sector's crowding out investible resources: at the same time, they were unable to access foreign capital markets. Clearly the banking system was in poor health in the 1980s.

What have been the major contours of the financial sector reforms in India? For the sake of completeness, these include removal of the erstwhile existing financial repression, creation of an efficient, productive and profitable financial sector; providing operational and financial autonomy to institutions; preparing the financial system for increasing international competition; introduction of private equity in public sector banks and their listing, opening the external sector in a calibrated manner; and promoting financial stability in the wake of domestic and external shocks.

The philosophy behind the financial sector reforms was to allocate resources efficiently to the real sector, promote economic growth, make the financial system globally competitive and resilient to shocks, mitigate risks to the financial system, and enable the opening of the external sector.

The financial sector reforms since the early 1990s could be analytically classified into two phases. The first phase — or the first generation of reforms — was aimed at creating an efficient, productive, and profitable financial sector that would function in an environment of operational flexibility and functional autonomy. In the second phase, or in the second generation reforms which started at the mid-1990s, the emphasis of reforms has been on strengthening the financial system and introducing structural improvements.

Till the early 1990s the Indian financial sector could be described as a classic example of "financial repression" a la McKinnon and Shaw. Monetary policy was subservient to the fisc. The financial system was characterized by extensive regulations such as administered interest rates, directed credit programmes, weak banking

structure, lack of proper accounting and risk management systems and lack of transparency in operations of major financial market participants. Such a system hindered efficient allocation of resources. Financial sector reforms initiated in the early 1990s have attempted to overcome these weaknesses in order to enhance efficiency of resource allocation in the economy.

Simultaneously, the Reserve Bank took a keen interest in the development of financial markets, especially the money, government securities and forex markets in view of their critical role in the transmission mechanism of monetary policy. As for other central banks, the money market is the focal point for intervention by the Reserve Bank to equilibrate short-term liquidity flows on account of its linkages with the foreign exchange market. Similarly, the Government securities market is important for the entire debt market as it serves as a benchmark for pricing other debt market instruments, thereby aiding the monetary transmission process across the yield curve. The Reserve Bank had, in fact, been making efforts since 1986 to develop institutions and infrastructure for these markets to facilitate price discovery. These efforts by the Reserve Bank to develop efficient, stable and healthy financial markets accelerated after 1991. There has been close co-ordination between the Central Government and the Reserve Bank, as also between different regulators, which helped in orderly and smooth development of the financial markets in India.

What have been the major contours of the financial sector reforms in India? For the sake of completeness, it is useful to have a quick run-down of these :

- Removal of the erstwhile existing financial repression
- Creation of an efficient, productive and profitable financial sector
- Enabling the process of price discovery by the market determination of interest rates that improves allocative efficiency of resources
- Providing operational and functional autonomy to institutions
- Preparing the financial system for increasing international competition
- Opening the external sector in a calibrated manner; and
- Promoting financial stability in the wake of domestic and external shocks.

Against this brief overview of the philosophy of financial sector reforms, we briefly touch upon reforms in various sectors and segments of the financial sector.

## 2.3 Reforms in the Money Market

Sukhmoy Chakravarty Committee on the Review of the working of the Monetary System in 1985, Vaghul Committee on Money Market in 1987, and Narasimham Committee on the working of Financial System has made important recommendations for the improvement of the Indian money market. Based on the recommendations the Reserve Bank of India has initiated a number of measures to widen and deepen the money market; the main ones of which are as follows :

**(i) Deregulation of money market Interest Rates**

- From May 1989, the ceiling on interest rates on the call money, inter-bank short-term deposits, bills rediscounting and inter-bank participation was removed and the rates were permitted to be determined by the market forces. Thus, the system of administered interest rates is being gradually dismantled

**(ii) Introduction of New Money Market Instruments**

- In order to widen and diversify the Indian money market RBI has introduced four major new money market instruments such as 182-days treasury bills, 364-day treasury bills, CDs (certificates of deposits) in 1989 and CPs (commercial papers in 1990)
  - Through these instruments the government, commercial banks, financial institutions and corporate can raise funds through the money market. They also provide investors additional instruments for investments.
  - In order to expand the investor base for CDs and CPs the minimum amount of investment and the minimum maturity periods are reduced by RBI.

**(iii) Reforms in Call and Term Money Market**

The reforms in call and term money market were done to infuse more liquidity into the system and enable price discovery despite the recommendation of the Vaghul Committee that call money market should be restricted to banks. RBI undertook several important steps to check the constraints and remove them systematically. It was in October 1998, RBI

announced that non-banking financial institutions should not participate in call/term money market operations and it should purely be an interbank operating segment and encouraged other participants to migrate to collateralized segments to improve stability. Also, reporting of all call/ notice money market transactions through negotiated dealing system within 15 minutes of conclusion of transaction was made mandatory. The volume of operations in this segment was not increased much even after the reforms.

**(iv) Repurchase Agreements (Repos)**

- RBI introduced repos in government securities in December 1992 and reverse repos in November 1996.
- Repos and reverse repos (instruments used for short-term liquidity management) help to even out short-term fluctuations in liquidity in the money market. They also provide a short-term avenue to banks to park their surplus funds.
- Through changes in repo and reverse repo rates RBI transmits policy objectives to entire money market

**(v) Liquidity Adjustment Facility (LAF)**

- RBI has introduced LAF from June 2000 as an important tool for adjusting liquidity through repos and reverse repos.
- Thus, in the recent years RBI is using repos and reverse repos as a policy to adjust liquidity in the money market and therefore, to stabilize the short-term interest rates or call rates.

**(vi) Setting up of the Discount and Finance House of India (DFHI)**

- In order to impart liquidity to money market instruments and help the development of secondary market in such instruments, DFHI was set up in April 25, 1988 jointly by RBI, public sector banks and financial institutions.Its major function is to bring into the fold of the Indian money market the entire financial system comprising of the scheduled commercial banks, foreign banks, cooperative banks and all–India financial institutions in the public and private sectors.In DFHI operations, the emphasis is placed on a high turnover in the money market.

- However, maturities of existing instruments like CDs and CPs were gradually shortened to encourage wider participation. Likewise ad hoc treasury bills were abolished in 1997 to stop automatic monetisation of fiscal deficit.

**(vii) Regulation of NBFCs (Non-bank Financial Corporations)**

- The RBI Act was amended in 1997 to provide for a comprehensive regulation of NBFC sector
- According to the amendment, no NFBC can carry on any business of a financial institution, including acceptance of public deposit, without obtaining a Certificate of Registration (CoR) from RBI.

**(viii) The Clearing Corporation of India Limited (CCIL)**

- The CCIL was registered on April 30, 2001 under the Companies Act, 1956, with the State Bank of India as the chief promoter
- The CCIL clears all transactions in government securities and repos reported on the Negotiated Dealing System (NDS) of RBI

With these reforms the money market is becoming vibrant.

## 2.4 Reforms in the Capital Market

In the early 1990s, the Indian capital market was seen as poorly regulated. Volumes of share trading were dominated by the Bombay Stock exchange (BSE), ostensibly a self-regulatory organization that resembled a closed cartel of broker members who acted purely in their own interest with little concern for other shareholders in the market. In 1991 the BSE's market capitalization rose by 130% within 7 months, when it was discovered that funds had been diverted from commercial banks to the stock market by one broker, and the bubble burst. That episode raised crucial questions about the design and enforcement of financial market regulation. The formal regulation of India's capital market can thus be said to have begun in 1992, when a four-year old regulatory authority, the SEBI (Securities and Exchange Board of India), was empowered by statute to regulate market intermediaries. This included regulating the markets for equity issuance, until then controlled by the government, which computed the issue price on the basis of accounting formula.

Financial sector reform encompasses the capital market reforms aimed at financing investment in the private sector and at attracting foreign portfolio capital. Foreign institutional investors are now allowed to invest in the capital market. The functioning of capital markets has also been improved by the liberalization of interest rates and the abolition of the complex approval system for financial transaction through the repealing of the Capital Issues (Control) Act, 1947 and abolishing the office of the Controller of Capital Issues. With this, companies no longer needed government approval for approaching the capital market. The reforms went on to permit companies to approach the international capital market through the issue of Euro-equities under the Global Depository Receipt (GDR)/ American Depository Receipt (ADR) mechanism. Further, to check malpractices, the Securities and Exchange Board of India (SEBI), an independent statutory regulation body which have been set up in 1988 as an apex regulator of Indian capital market, was given statutory powers to rationalize stock exchange. This appears to have helped the market recover from a major securities scandal in which bank funds were illegally siphoned off into the stock market. SEBI is required by law to protect the interests of the three groups constituting the capital market: issues of securities, investors (both small and big ), brokers and other market intermediaries. SEBI is empowered to setting up regulations (primary-market regulations and secondary-market regulations) for the Indian capital markets:

In fact, in many respects the financial sector reforms are the most 'technical' among the many different reforms on the national agenda. The task before the country is to make her a competitive force in international financial markets. This time the government has shifted from direct control of financial allocation to indirect regulation. Resources are now allocated more closely in accordance with the profit motives of the private sector rather than the preference of the state.

**REFORMS**

Indian capital market what it is today was not the case same 30 years back. The so-called reform in the Indian capital market was started after the famous Rs. 4000 crore securities scam of Harshad Mehta in 1992 which exposed the loopholes in the financial system in India. This incidence shattered the confidence of the investor. The later governments took serious steps to bring a reform in the entire system with the objective of bringing transparency in the system. The 1991-92 securities scam prompted the government to increase the pace of reforms in the capital market.

Several reform measures have been undertaken since then in both the primary and secondary segments of the equity market.

**The Primary Capital Market**

- A significant step forward in capital market reforms was the passing of theThe Securities and Exchange Board of India (SEBI). SEBI was set up in early 1988 as a non-statutory body under an administrative arrangement. It was given statutory powers in January 1992 through the enactment of the SEBI Act, 1992 for regulating the securities market. The two objectives mandated in the SEBI Act are investor protection and orderly development of the capital market.
- The Capital Issues (Control) Act, 1947 was repealed in May 1992, allowing issuers of securities to raise capital from the market without requiring the consent of any authority either for floating an issue or pricing it. Restrictions on right and bonus issues were also removed. The interest rate on debentures was freed. However, the new issue of capital has now been brought under the SEBI's purview and issuers are required to meet the SEBI guidelines for disclosure and investor protection, which are being strengthened from time to time to protect investor interest.
- The infrastructure of the primary capital market has been fairly diversified over the years with the setting up of a large number of merchant bankers, investment and consulting agencies, and registrars to the issue.
- The primary capital market has widened and deepened with public sector banks, financial institutions, and public sector enterprises in the infrastructure and power sectors increasingly raising resources from the market both by way of debt and equity.
- Although the process of institutionalization of the market on the supply side started in 1987-88 when many mutual funds sponsored by banks and financial institutions were set up, it gained considerable momentum in the early 1990s when many mutual funds were set up in the private sector. There are now 44 mutual funds houses operating in the country with assets worth of Rs. 24,03,134 crore, while there were 33 mutual funds with total assets of Rs. 1,21,805 crore.

- The requirement to issue shares at a par value of Rs.10 and Rs.100 was withdrawn. This gave companies the freedom to determine a fixed value per share. This facility is available to companies which have dematerialized their shares. Moreover, the shares cannot be issued in the decimal of a rupee.
- Improved disclosure standards, prudential norms, and simplified issue procedures have been prescribed. Companies are required to disclose all material facts, specific risk factors associated with their projects while launching public issues and give justification for pricing on their prospectus. The offer document is not vetted by the SEBI.
- To reduce the cost of the issue, underwriting by the issuer was made optional.
- One of the significant steps towards integrating the Indian capital market with the international capital markets was the permission given to foreign institutional investors such as mutual funds, pension funds, and country funds, to operate in the Indian market. Foreign institutional investors were initially allowed to invest only in equity shares; later, they were allowed to invest in the debt market, including dated government securities and treasury bills. The ceiling for investment by foreign institutional investors was increased from 40 per cent to 49 per cent in 2000-01.
- Indian companies have also been allowed to raise capital from the international capital markets through issues of Global Depository Receipts, American Depository Receipts, Foreign Currency Convertible Bonds (FCCBs) and External Commercial Borrowings (ECBs). Companies were permitted to invest all ADR/GDR proceeds abroad. Converted local shares could be reconverted into ADRs/GDRs.
- Various bottlenecks on the floatation of new capital issues, particularly for infrastructure projects, were removed.
- With a view to helping infrastructure companies raise funds for their projects, their debt instruments are allowed to be listed on the stock exchanges without prior listing of equity. Corporates with infrastructure projects and municipal corporations are exempted from the requirements of Rule 19(2)(b) of the Securities (Contracts) (Regulation) Act, 1956 to facilitate the public offer and listing of its pure debt instruments as well as debt instruments fully or partly convertible into equity without requirement of prior listing of equity but arc subject to conditions such as investment grade rating.

- Unlisted Companies now will have to demonstrate an ability to pay dividend instead of showing an actual dividend paying record.
- Merchant bankers are prohibited from carrying on fund-based activities other than those related exclusively to the capital market. Multiple categories of merchant bankers have been abolished and there is only one entity, the merchant banker.
- Besides merchant bankers, various other intermediaries such as mutual funds, portfolio managers, registrars to an issue, share transfer agents, underwriters, debenture trustees, bankers to an issue, custodian of securities, venture capital funds and issues have also been brought under the purview of the SEBI.
- The prescription of the minimum margin of 50 per cent of loans to individuals against preference shares and debentures/bonds of corporate bodies is withdrawn. However, the margin of 50 per cent prescribed in respect of equity shares has been retained
- A code of conduct on advertisement has been issued for mutual funds, banning them from making any assurance or claims that might mislead the public.
- The entry norms for IPOs have been tightened by modifying the Disclosure and Investor Protection (DIP) guidelines. According to the new guidelines.
- The SEBI DIP (Disclosure and Investor Protection) Guidelines, 2000 have been amended. Permission has been granted to foreign venture capital investors (FVCIs) registered with the SEBI and State Industrial Development Corporations (SIDCs) to participate in public issues through the book building route as qualified institutional buyers (QIBs). There is no lock-in requirements for the pre-issue capital of an unlisted company held by venture capital funds (VCFs) and FVCIs.
- Companies in the IT, telecom, media, and entertainment sectors are allowed to tap the market with a minimum offering of 10 per cent of their equity.
- The issuer can make a public or rights offer of shares in demat form only. Investors have the option of subscribing to securities in either the physical or the dematerialized form.

- Every public-listed company making an IPO of any security for Rs.10 crore or more is required to make an offer only in a dematerialized form.
- The SEBI prescribed new guidelines for regulating private placement of debt securities issued by the corporates. These guidelines aim to enhance transparency and protect the interest of investors in the debt securities.
- The SEBI introduced the green-shoe option facility in IPOs as a stabilization tool for the post listing price of newly issued shares.
- The Central Listing Authority was set-up to ensure uniform and standard practices for listing the securities on stock exchanges.
- In 2001, the SEBI guidelines mandated a minimum level of public holding at 25 per cent for companies carrying out with fresh IPOs. Companies in infotech, media, and telecom sector were allowed to go public with a 10 per cent public stake. In 2008, the government has made it mandatory for all listed firms, which do not have a public shareholding of 25 per cent, to increase their shareholding annually by 3-5 per cent.
- In March 2003, the SEBI introduced sweeping changes in IPO norms to boost investor confidence. It changed the eligibility criteria for IPOs.
- On March 29, 2005, the SEBI redefined the retail individual investor as one who applies or bids for securities of or for a value not exceeding 1 lakh.
- Shares will now be allotted on a proportionate basis within the specified categories, with the predetermined minimum allotment being equal to the minimum application size.
- During 2005-06 SEBI Disclosure and Investor Protection (DIP) Guidelines, 2000 relating to book building issues were amended to introduce a specific allocation of 5 per cent for mutual funds.
- To assist the retail investors, SEBI gave in-principle approval for grading of IPOs by the rating agencies at the option of the issuers. SEBI will not certify the assessment made by the rating agencies.
- The disclosure requirements were rationalized during the year. Listed companies which have a satisfactory track record of filing periodic returns with the stock exchanges arc exempted from repetitive disclosures in case of rights and public issues by them.

- The facility of electronic clearing services (ECS) was extended to refunds arising out of public issue so as to ensure faster and hassle free refunds.
- Companies are permitted to take multiple routes to raise capital at the same time Companies are now only required to update their prospectus with details about the additional capital being raised through other routes.
- Venture Capital and private equity forms are barred to sell their stake in a company after its IPO.
- Issuance of bonds which are below investment grade will be allowed to the public to suit the risk/ return appetite of investors.
- In order to enable listed companies to raise equity through rights and follow-on issues in a short span of time, SEBI amended the DIP guidelines.
- SEBI has allowed companies to give discount of up to 10 per cent to retail investors in public offers.
- All investors, including retail investors are allowed to invest in Indian Depository Receipts (IDRs). The minimum investment limit has been reduced from Rs. 2,00,000 to Rs. 20,000.
- SEBI launched an alternate payment system called Applications Supported by Blocked Amount (ASBA) for public and rights issues in August 2008.
- PAN has been mandatory in all public and rights issues irrespective of the application amount. SEBI exempted investors residing in the state of Sikkim from the mandatory requirement of PAN for the purpose of opening/operating Beneficial Owner (BO) accounts with depository participants and trading in cash market, respectively.

**Secondary Capital Market**

- The open outcry trading system, prevalent till 1995, was replaced by the on-line screen-based electronic trading. In all, 23 stock exchanges have approximately 8,000 trading terminals spread all over the country.
- Three new stock exchanges at the national level were set up in the 1990s. These were : the Over the Counter Exchange of India (1992), the National Stock Exchange of India (1994), and the Interconnected Stock Exchange of India (1999).
- Trading and settlement cycles were uniformly trimmed from 14 days to 7

days in all stock exchanges in August 1996. Rolling settlement (T+5) was introduced in January 1998 for the dematerialized segment of all companies. With effect from December 31, 2001, all scrips have come under rolling settlement. The settlement cycle for all securities was shortened from T+5 to T+3, with effect from April 1, 2002.

- With a view to maintaining integrity and ensuring safety of the market, various risk containment measures have been initiated or strengthened, such as the mark to market margin system, intra-day trading limit, exposure limit, and setting up of trade/settlement guarantee fund. Stock exchanges are allowed, subject to conditions, to use the settlement guarantee funds (SGFs). The NSE set up a separate clearing corporation—The National Securities Clearing Corporation—to act as a counter-party to all trades executed in the capital market segment of the exchange. An important reform step to the passing of the SEBI Act was the setting up of the National Stock Exchange (NSE) to provide competition to the BSE. One of the principles for setting up the NSE was to facilitate access to investors from all over India.
- To enhance the level of investor protection, the process of dematerialization of securities through the depository system and their transfer through electronic book entry is pursued vigorously. To enable this, the National Securities Depository Limited was set up in November 1996 and the Central Depository Service Limited in February 1999. All actively traded securities are held, traded, and settled in demat form.
- Badla--the carry forward trading mechanism was reinstated in January 1996, with safeguards in line with the recommendations of the Patel Committee (1995) and the Varma Committee (1996). The cash segment was strengthened. All deferral products including badla have been discontinued from July 2001 following the scam of March 2001.
- Issuing companies are required to make continuing disclosures under the listing agreement. All listed companies are required to furnish to stock exchanges and also publish unaudited financial results on a quarterly basis. Disclosure of material information is also required to be made available to the public.
- One of the most significant reforms in the secondary market is the measure to improve corporate governance. Corporate governance is a set of systems

and processes designed to protect the interests of stakeholders. It is about commitment to values, ethical business conduct, and a high degree of transparency. It is about creating and enhancing shareholder wealth while protecting the interests of all other stakeholders. The SEBI had appointed a committee under the chairmanship of Kumar Mangalam Birla on corporate governance in India. The committee framed the codes for corporate governance and suggested the implementation of the code through stock exchanges.

- Stock exchanges have also undergone some major structural reforms. The boards of various stock exchanges have been made broad-based so that they represent different interests and not just the interests of their members. Stock exchanges, brokers, and sub-brokers have been brought under the regulatory purview of the SEBI.
- Companies are allowed to buy back their own shares for capital restructuring, subject to the condition that the buy back does not exceed 25 per cent of the paid-up capital and free reserves of the concerned company. This buy back has been allowed to improve liquidity and enhance wealth of the shareholder.
- The insider trading regulations have been formulated prohibiting insider trading and making it a criminal offence, punishable in accordance with the provisions under the SEBI Act, 1992.
- Regulations are also in place for take over and substantial acquisition of shares to make the takeover process more transparent and mindful of the interests of small shareholders. In September 2002, the SEBI amended the Takeover Code by accepting the Bhagwati Committee recommendations on takeovers. As per the new code, if an acquirer gains control of over 15 per cent in a company which already owns 15 per cent in another company, the acquirer has to declare open offers for sharehold¬ers of both the companies.
- An index-based market wide 'circuit breaker' system has also been introduced to check a sudden rise in security price, in speculation and over-trading. This system becomes active at three stages of the index movements.
- In February 1999, trading terminals were allowed to be set up abroad for facilitating market participation by non-residents. Internet trading was permitted in February 2000.
- For ensuring greater market transparency, SEBI, in 1999, banned negotiated and cross deals (where both the seller and buyer operate through the same

broker). Moreover, all private off-market deals in both shares as well as listed corporate debts were banned. So these deals are routed only through trading screens.

- Since June 2000, trading of futures has begun. Both the NSE and the BSE have created proper facilities for derivatives trading, including conducting of regular training programmes for the same. The Securities Contracts (Regulation) Act, 1956 has been amended,
- It is mandatory for listed companies to announce quarterly results. This enables investors to keep a close track of the scrips in their portfolios.
- To check price manipulation, mandatory client code and minimum floating stock for continuous listing were stipulated in November 2001.
- The government amended the Securities Contracts (Regulation) Rules, 1957 to standardize listing requirements at stock exchanges.
- A 99 per cent value at risk (VaR) based margin system for all scrips in rolling settlement was intro¬duced from July 2, 2001.
- The central government has notified the establishment of the Investor Education and Protection Fund (IEPF) with effect from October 1, 2001. The IEPF will be utilised for the promotion of aware¬ness amongst investors and protection of their interests.
- The restriction on short sales announced in March 7, 2001, was withdrawn with effect from July 2, 2001, as all deferral products stand banned after that date.
- It is mandatory for all brokers to disclose all details of block deals.
- With a view to providing greater liquidity in the secondary securities market, the SEBI allowed corporate brokers with a net worth of at least Rs. 3 crore to extend margin trading facility to their clients in the cash segment of stock exchanges.
- A clearing corporation/clearing house, after registration with the SEBI, under the SEBI scheme for Securities Lending and Borrowing, as an approved intermediary may borrow securities for meeting shortfalls in settlement on behalf of the member.
- The SEBI has made it mandatory for every intermediary, to make an

application for allotment of unique identification numbers for itself and for its related persons, under the SEBI (Central Data Base of Market Participants) Regulations, 2003. This move aims to promote up-to-date information about all market participants.

- Stock exchanges were advised to amend Clause 41 of the Listing Agreement to make it mandatory for listed companies to publish the number of investor complaints received, disposed of, unresolved along with quarterly results.
- Clearing and settlement cycle time was further contracted to T+2 with effect from April 1, 2003
- SEBI specified that no single investor should hold more than 25 per cent of the corpus of any scheme/plan.
- SEBI allowed mutual funds to invest in derivative securities.
- Interest rate futures contracts were introduced in June 2003 and futures and options contracts on sectoral indices were introduced in August 2003.
- FIIs and NRIs were permitted to invest in all exchange-traded derivative contracts.
- Stock brokers were allowed to trade in commodity derivatives.
- FIIs were allowed to participate in delisting offers, sponsored ADR/GDR programmes and disinvestment by the government in listed companies.
- In order to facilitate execution of large trades without impacting the market, the stock exchanges were permitted to provide a separate trading window for block deals subject to certain conditions. The BSE and the NSE activated this window with effect from November 14, 2005.
- In order to prevent off-market trades prior to the commencement of trading, the International Securities Identification Numbers (ISINs) of IPOs will be activated by the depositories only on the date of commencement of trading on the stock exchanges.
- In order to protect the interest of minority shareholder, the Securities Contracts (Regulation) Act was amended in 2004 to recognize delisting.

These apart, a company can opt for delisting if it has been listed in a recognized exchange for a minimum period of three years or the delisting has been approved by three-fourth of the shareholders in a general body meeting

SEBI amended the listing agreement in December 2007 to improve the transparency with regard to utilization of issue proceeds.

From April 21, 2008, all institutional trades in the cash market arc margined on a T+l basis with margin being collected from the custodian upon confirmation of the trade. Subsequently, with effect from June 16, 2008, the collection of margins moved to an upfront basis.

In April 2008, SEBI allowed all classes of investors to short sell subject to a broad framework. SEBI also set up a full-fledged securities lending and borrowing (SLB) scheme for all participants in the market. Naked short selling is not allowed and FIIs are prohibited from day trading.

Comprehensive risk management for the cash market has been specified by SEBI. In September 2008, SEBI introduced trading in rights entitlements.

Mutual fund distributors have been allowed to use stock exchange infrastructure for mutual fund distribution.

## 2.5 Progress after Reforms

A review of money and capital market with an on-look in their reforms processes and their current status show that India is not lagging behind in any significant manner.

### 2.5.1 Progress in money market

Numerous Committees, viz. Chakravarty Committee of 1985, Vaghul Commmittee of 1987, Narasimham Committees of I & II of 1991 and 1998, respectively, made several recommendations, which have ultimately resulted in the development of a modern organized money market.

The post reforms period saw significant gains in the money market, besides institutional development and procedural reforms. Following reforms, what has happened actually is laid down below :

(i) Deregulation of money market interest rate helped make interest rates flexible and lending transparency to transactions in the money market.

(ii) Following the reforms, several new instruments (CDs and CPs, repos,

Collateralized lending and borrowing obligations (CBLO) etc.) have broadened.

(iii) Introduction of repos and reverse repos has tackled the problem of high inflation. Moreover, the institution of new standing facility (MSF) by the RBI helps scheduled commercial banks borrow overnight funds.

(iv) Setting up of the new institutions like DFHI (now SBI DFHI Ltd), STCI and CCIL have added strength to the Indian money market, and made price discovery more efficient, and transaction-cum–settlement process smoother.

(v) Introduction of money market mutual funds is a step on the right direction. These have provided an additional short-term avenue to investors and brought money market instruments within the reach of the individuals.

(vi) Following the reforms in the call/notice money market, banks and primary dealers (PDs) are operating as both lenders and borrowers.

(vii) Most of the constraints on the term money market have been removed by the RBI in recent years. As a result there have been some activities in the term money market ; and

(viii) One of the main systemic changes in the money market was the introduction of Liquidity adjustment Facility (LAF) which has changed the dynamics of the shorn-term money market.

So there are some progresses in the money market following the reforms, yet we can say that while a base has been credited with a variety of products in the money market, the market has not acquired depth in terms of both volume and liquidity. So we expect that the institutional and other reforms will provide the necessary path for the future. With that the Indian money market will get integrated with debt and foreign exchange markets and may pave the way for the RBI's smooth operation of the money market.

### 2.5.2 Progress in Capital Market

The twin forces of liberalization and globalization have transformed the Indian capital markets enormously. Changes have been rapid and visible; and today India's capital markets can be compared with the most advanced ones elsewhere, in certain respects.

India's financial and capital market reforms since the early nineties have positively impacted on the performance of the banking sector and the capital market. High-quality firms—defined as those that are profitable, have access to the commercial paper market and face relatively stable profitability—have reduced the proportion of loans further in 1997-2001 as compared with the period of 1992-96. This tendency strengthened during the period when the IPO requirement was tightened and the stock-market boom collapsed (so that many firms increased recourse to bank loans). This indicates that the capital market has succeeded in differentiating high-quality firms from low-quality ones, thereby making it cheaper for the former to raise funds from the market. Given the frequent cases of malpractice and price riggings, however, the government still needs to make continuous efforts to improve the infrastructure by strengthening penalty associated with malpractice, tightening accounting and auditing standards, and providing timely and precise information.

Following the reform in capital market, the Indian economy is growing at a good speed. It has attracted a huge inflow of Foreign Institutional Investments (FII). The massive entry of FIIs in the Indian capital market has given good appreciation for the Indian investors in recent times. Similarly, many new companies are emerging on the horizon of the Indian capital market to raise capital for their expansions. Besides, there were net inflows to the tune of Rs. 2.1 lakh crore on account of the foreign portfolio investors (FPIs) in the Indian capital market during 2020-21 (Economic Survey, 2020-21), as compared to net inflows of Rs. 0.81 lakh crore during the same period in 2019-20.

People from different parts of the country are now having access to the stock market. As on 31/3/2018, the turn over of BSE, NSE and MSE is estimated at Rs. 11082968.24 and Rs. 7234825.69 crore and Rs. 19277 crore respectively. Investors carefully watch the performance of the stock markets by observing market index, before investing their funds. This index becomes a yardstick to compare the performance of other investment avenues.

**Equity Issuance and Market Capitalization**

Along with the emergence of NSE as a dominant player among Indian stock exchanges, public equity issues have increased over the years. Table 2.1 details the rising volumes of equity issuance except the year 2015–16, 2019–20.

**Table 2.1: Public* Equity Issues**

| Year | Rupees Crore |
|---|---|
| 2004-05 | 82,822 (2.6) |
| 2005-06 | 96,323 (2.7) |
| 2006-07 | 1,45,809 (3.5) |
| 2007-08 | 2,11,158 (4.5) |
| 2010-11 | 52,443 |
| 2015-16 | 26,432 |
| 2017-18 | 99,765 |
| 2019-20 | 77,049 |
| 2020-21 | 110,119 |
| 2021-22 | 111,725 (till Nov 30) |

Sources : SEBI and RBI

Notes:* Public and Rights Issues. Equity public issues listed in SME platform. The data is based on the listing data.

Figures in parentheses are percentage of GDP.

The stock market capitalization of listed Indian companies has also grown and currently, as a percentage of GDP, it is comparable with developed countries. As on 31/3/2018, the stock market capitalization has increased 28 times compared to 1995-96. Besides, the Indian stock market has witnessed a phenomenal growth in share turnover over the years.

**Rising Electronic Transactions**

Due to technological development in the last few years, the physical transaction with more paper work is reduced. Now paperless transactions are increasing at a rapid rate. It saves money, time and energy of investors. Thus it has made investing safer and hassle free encouraging more people to join the capital market.

**Growing Mutual Fund Industry**

The growing of mutual funds in India has certainly helped the capital market to grow. Public sector banks, foreign banks, financial institutions and joint mutual funds

between the Indian and foreign firms have launched many new funds. A big diversification in terms of schemes, maturity, etc. has taken place in mutual funds in India. It has given a wide choice for the common investors to enter the capital market. Of late, there was a net inflow of Rs. 2.76 lakh crore into the mutual funds industry during 2020-21.

**Growing Stock Exchanges**

The numbers of various Stock Exchanges in India are increasing. Initially the BSE was the main exchange, but now after the setting up of the NSE and the OTCEI, stock exchanges have spread across the country. Recently a new Inter-connected Stock Exchange of India has joined the existing stock exchanges.

**Investor Protection**

Indian stock exchanges have instituted settlement guarantee and investor protection funds to protect the interests of investors. The National Securities Clearin Corporation (NSCCL) carries out clearing functions and guarantees settlement, and the Clearing Corporation of India (CCIL) settles and clears trades in government securities and foreign exchange. Over time, the NSE and the NSCCL have put together effective risk management systems including the adequacy of capital, position limits, and margins.

Besides under the purview of the SEBI the Central Government of India has set up the Investors Education and Protection Fund (IEPF) in 2001. It works in educating and guiding investors. It tries to protect the interest of the small investors from frauds and malpractices in the capital market.

**Foreign Institutional Investors (FIIs)**

Foreign investment in Indian stock markets was initiated when FIIs were allowed to register with SEBI in November 1992, and investments came in from January 1993. The opening up of Indian equity markets to foreign investors has had the benefial side effect of improving domestic corporate governance. Moreover, this has also helped Indian companies to access capital from international markets through ADRs and GDRs.

Foreign Investments in Indian GDPs and ADRs also rose sharply from 2005-06 to 2007-08. On average, FII investors have profited from their investments in India. India has benefitted as well, since FII presence has led to a greater international investor confidence in Indian euity market valuations. In sum, FII investments and

participation in Indian markets has had a salutary effect on trading practices, and contributed to increasing efficiency levels as is evident from contracting bid-ask spreads.

**Dematerialization**

National Securities Depository Limited (NSDL), set up in November 1996, has implemented efficient paperless clearing mechanisms. Securities can now be held in depository accounts, dividends received, and shares transferred without any movement of paper.

In 1998, the value of dematerialized securities held in the NSDL amounted to US$ 5 billion. As of end 2007, the value of such securities became US$ 1 trillion, which is a 200-fold increase in ten years. This is a reflection of the increase in the number of account holders.

**Market Integrity**

By the late 1990s, Indian equity markets were already ahead of the banking insurance, and pension sectors in terms of efficiency. However, along with liberalization and deregulation in the 1st two decades of economic reforms, there were periodic episodes of widespread wrong-doing. The first major episode in 1992 was occasioned by Harshad Mehta's activities, which included borrowing overnight funds from banks for investments in the equity markets. Such a ponzi strategy could not be sustained.

Badla transactions used to be executed on Indian stock exchanges in the 1990s. This was an Indian version of the Contango, which used to be practised on the London Stock Exchange. Badla was banned after the Harshad Mehta scam, however, broker and investor lobbies were able to get the ban revoked. Other scams that occurred from the mid-1990s to 2002, involved names such as C.R.Bansali, Ketan Parekh, Canara Bank etc.

On a positive note, it is a matter of some satisfaction that there have been fewer instances of large scale manipulation in Indian equity markets since 1992. This is probably due to the elimination of Badla and the introduction of rolling settlement and exchange traded derivatives.

**Private Equity and Venture Capital**

These two are important in promoting innovation. In India, the responsibilities

for developing these segments of the equity market have not been clearly defined across the financial sector regulators.

**Growth of Securities market**

Since massive liberalization launched in 1991, securities market in India has grown exponentially as measured in term of the amount of funds raised from the market, number of market participants, the number of listed companies, market capitalization, trading volumes and turnover on stock exchanges, and investor population.

**Growth of Derivative Transactions**

Since June 2000, the NSE has introduced the derivatives trading in the equities. In November 2001 it also introduced the future and options transactions. These innovative products have given variety for the investment leading to the expansion of the capital market. There are two categories of derivatives transactions (a) those that are traded on stock exchanges; and (b) others that are tailored by market makers to meet specific hedging. The second category is called OTC derivatives. Market participants in exchange traded derivatives could be individuals or institutions while OTC derivatives players are predominantly institutions.

**Insurance Sector Reforms**

Indian insurance sector has also witnessed massive reforms in last few years. The Insurance Regulatory and Development Authority (IRDA) was set up in 2000. It paved the entry of the private insurance firms in India. As many insurance companies invest their money in the capital market, it has expanded.

**Commodity Trading**

Along with the trading of ordinary securities, the trading in commodities is also recently encouraged. The Multi Commodity Exchange (MCX) is set up. The volume of such transactions is growing at a splendid rate.

In sum, the Indian capital market has experiencing metamorphic changes since the 1990s.Indian Capital market is already in the growth face. A clear policy decision from government, vigilant eye from the regulators, transparency from the stock exchanges & prudent action by the brokers & financiers is the requirement of the day to maintain the growth rate on the Securities Market. A strong capital market provides the foundation for a developed economy.

## 2.6 Conclusion

To conclude, the financial system in India, through a measured, gradual, cautious, and steady process, has undergone substantial transformation. It has been transformed into a reasonably sophisticated, diverse and resilient system through well-sequenced and coordinated policy measures aimed at making the Indian financial sector more competitive, efficient, and stable. Concomitantly, effective monetary management has enabled price stability while ensuring availability of credit to support investment demand and growth in the economy. Finally, the multi-pronged approach towards managing capital account in conjunction with prudential and cautious approach to financial liberalization has ensured financial stability in contrast to the experience of many developing and emerging economies. This is despite the fact that we faced a large number of shocks, both global and domestic. Monetary policy and financial sector reforms in India had to be fine tuned to meet the challenges emanating from all these shocks. Viewed in this light, the success in maintaining price and financial stability is all the more creditworthy.

So far as the Indian capital market is concerned, it has witnessed a radical transformation within a period of just over three decades. During the early part of the 1990s, the ranking of Indian capital market was low. However, the scenario has now completely changed. Because of extensive capital market reforms carried out over the last three decades, the setting up and extension of activities of NSE and steps taken by SEBI, the Indian capital market is now considered to be way ahead of many developed country capital markets.

## 2.7 Summary

**Badla :** It is the forwardation charge that the buyer in a stock transaction pays to the seller of stocks.Badla or the carry forward system was another unique feature of the BSE. This facilitated brokers to carry forward their positions and leverage. This 135-year-old badla system was banned in 1993 by the SEBI. Later, J.R. Verma Committee recommended a modified carry forward system (MCMS) which was accepted by the SEBI.

**Capital market :** A market for securities (both debt & equity), where business enterprises (companies) and governments can raise long-term funds. It is defined as a market in which money is lent for periods greater than a year, as the raising of

short-term funds takes place on other markets (e.g., the money market). The capital market includes the stock market (equity securities) and the bond market (debt). Capital markets consist of primary markets (i.e., a part of the capital markets that deals with the issuance of new securities. Governments, Companies or public sector institutions can obtain funding through the sale of a new stock or bond issue. This is typically done through a syndicate of securities dealers) & secondary markets (The secondary markets are where existing securities are sold & bought from one investor or trader to another, over the counter, usually on a securities exchange, or elsewhere.).

Exchange traded and over-the- counter (OTC) derivatives markets were developed in the 1980s, and are now deemed to be part of capital markets.

**Why Capital Markets are important ?** Well-developed capital markets are a driver of economic growth, and thereby yield positive effects on employment. The correlation between capital market development and economic growth has been well-established in the empirical literature. Capital markets mobilize additional savings into the economy, making more capital available to companies, which may then in turn create jobs and facilitate real-wage growth. At the same time, some evidence exists that capital markets are associated with higher productivity levels as the allocation of resources becomes more efficient—including through better information, mechanisms to control good governance, and the provision of capital to innovative projects.

On a micro-level, well-developed capital markets constitute an important source of financing for corporations.

From the investors' perspective, capital markets offer investment opportunities and risk management tools. First, capital markets can offer more attractive investing opportunities in terms of their return than bank deposits, albeit with a higher risk. Further, if a wide range of instruments exist, then capital markets can provide investors with a diversified portfolio, which contributes to risk management. This is of particular importance to pension funds and insurance companies in countries that have young populations because higher rates of return are necessary to ensure an adequate payout in the future. Finally, well-developed capital markets also provide risk management tools through the derivatives markets.

Besides economic growth, well-regulated and supervised capital markets may enhance financial stability. In addition, the potential contribution of capital markets to economic growth in emerging and developing economies is even more relevant today, given the challenge of the Sustainable Development Goals (SDGs).

**Capital Market reforms :** Apart from the banking system, financial sector reform also encompasses the reform of capital markets aimed at financing investment in the private sector and at attracting foreign portfolio capital. Foreign institutional investors, such as mutual and pension funds, are now allowed to invest in the capital market.

A second route for foreign portfolio investment has been the issue of shares abroad by Indian Companies, and several Indian corporations have mobilized significant amounts of capital in this way.

Interest rates in the domestic capital market have been deregulated, and the need for prior government approval of the size and price of equity issues in the primary capital market has been dispensed with. The deregulated capital market is to be overseen by the SEBI (Securities and Exchange Board of India) , an independent statutory regulatory body that introduced a framework of rules and regulations to govern trading practices, standards of disclosure, speed of settlement, and transparency of transactions. This appears to have helped the market recover from a major securities scandal in which banks funds were siphoned off into the stock market. A new National Stock Exchange with computerized screen trading has commenced operation, and other stock exchanges are being computerized and modernized.

**Certificates of Deposit (CDs) :** CDs represent essentially securitized and tradable term deposits. In India, CDs were first introduced in 1989. The terms and conditions for issuing CDs like eligibility, maturity periods, size, transferability, applicability of reserve requirements, etc., are stipulated by the Reserve Bank. CDs in general represent relatively a high cost liability.

**Commercial Paper (CP) :** A money market instrument, issued in the form of a promissory note, by highly rated corporates for a fixed maturity in a discounted form. CP was introduced in India in 1989 to enable highly rated corporate borrowers to diversify their sources of short-term borrowing and also to provide an additional instrument to investors. Terms and conditions for issuing CP like eligibility, modes of issue, maturity periods, denominations and issuance procedure, etc., are stipulated by the Reserve Bank.

**Financial repression :** The term was dubbed by McKinnon (1973) and Shaw (1973). It is characterized by extensive regulations such as administered interest rates, directed credit programmes, weak banking structure, lack of proper accounting, prudential norms and risk management systems in the banking operations, and lack

of transparency in operations of major financial market participants and, finally lack of incentive to seek efficiency. Moreover, after the nationalization of banks in 1969 and 1980 in case of India, 90 per cent of banking assets were in government-owned banks and financial institutions, while the entry of foreign banks was restricted. Hence, there was a significant lack of competition in the financial sector. Such a system hindered efficient allocation of resources. Financial sector reforms in India initiated in the early 1990s have attempted to overcome these weaknesses in order to enhance efficiency of issuance allocation in the economy.

**Money market :** A market for short-term funds, i.e., up to one-year maturity. Thus, it covers money, and financial assets that are close substitutes for money. The money market is generally expected to perform three broad functions. First, it should provide an equilibrating mechanism to even out demand for and supply of short-term funds. Second, the money market should provide a focal point for central bank intervention for influencing liquidity and general level of interest rates in the economy. Third, it should provide reasonable access to providers and users of short-term funds to fulfill their borrowing and investment requirements at an efficient market clearing price.

One of the sections of a financial market where securities and financial instruments with short-term maturities are traded is called the money market. Financial assets like treasury bills, certificates of deposits, commercial paper and bankers' acceptance are some of the short-term debt securities traded in the money market. The money market consists of financial institutions and dealers in money or credit who wish to either borrow or lend. Participants borrow and lend for short periods, typically up to thirteen months. Money market trades in short-term financial instruments commonly called "paper". This contrasts with the capital market for longer-term funding, which is supplied by bonds and equity. The money market has traditionally been defined as the market for short-term marketable debt instruments, such as commercial paper (CP) and treasury bills (TBs). It is much more than this. It embraces all short-term lending and borrowing, marketable and non-marketable, and includes the significant interbank market. It is in this market that interest rates have their genesis. The Money market in India is the money market for short-term and long-term funds with maturity ranging from overnight to one year in India including financial instruments that are deemed to be close substitutes of money. Similar to developed economies the Indian money market is diversified and has evolved through many stages, from the conventional platform of treasury bills and call money to commercial paper, certificates of deposit, repos, forward rate agreements

and most recently interest rate swaps. Money market, a set of institutions, conventions, and practices, the aim of which is to facilitate the lending and borrowing of money on a short-term basis. The money market is, therefore, different from the capital market, which is concerned with medium and long-term credit.

**Functions of the money market**

**A. Financing industry :** It helps to the growth of industries in two ways : (i) They help industries secure short-term loans to meet their working capital requirements through the system of finance bills, commercial papers, etc.; (ii)The short-term interest rates of the money market influence the long-term interest rates of the capital market. Thus, money market indirectly helps the industries through its link with and influence on long-term capital market.

**B. Finance trade :** It helps in financing domestic and international trade.

**C. Profitable investment :** The Money Market enables the commercial banks to use their excess reserves in profitable investment. Commercial banks are owned by shareholders and function for the purpose of generating profits.

**D. Self-sufficiency of commercial bank :** Developed money markets help the commercial banks to become self-sufficient. Commercial banks help to mobilize savings of the people for productive purposes. They collect scattered and idle savings of people, pool them together and make fund available for productive purposes. Commercial banks provide short-term and medium-term loans for industries, trade and commerce at reasonable rates of interest. Easy loans attract the investors to invest in new enterprises. The banks act as a brigade between savers and investors.

**E. Help to central bank :** Money markets help central banks in two ways:

(i) Guide the central bank to adopt an appropriate banking policy,

(ii) Secure quick and widespread influence on the submarkets, thus facilitating effective policy implementation.

**Characteristics of the Indian money market :** (1) Lack of integration: more of competition than cooperation and co-ordination between various components of the Indian money market; (ii) Lack of rational interest rates structure; (iii) absence of an organized ill market' (iv) Shortage of funds in the money market; (v) Seasonal stringency of funds and fluctuations in interest rates; and (vi) Inadequate banking facilities.

**Money market mutual funds :** A special type of mutual fund which invests in short-term money market instruments such as government securities, commercial paper, call money, certificate of deposits, etc. The benefits of higher yield that these investments are likely to generate are passed on to the investors.

**Primary Market :** The primary market is a market for new issues. It is also called the new issues market. It is a market for fresh capital. Funds are mobilized in the primary market through prospectus, right issues and private placement.

**Repos and Reverse repos :** These are instruments used for short-term liquidity management. Repo is the rate at which banks borrow from the RBI while reverse repo is used to drain excess cash lying with the bank. An increase in these rates signals arise in interest rates. To tackle the problem of high inflation in the economy in recent times, the RBI has been hiking these rates on a regular basis.

**Reverse repo rate :** It is the rate of interest offered by RBI, when banks deposit their surplus funds with the RBI for short periods T + 2 Settlement Cycle: Currently in the Indian Capital market, the settlement cycle is in the "T+2" cycle. Here, 'T' means the trading day and the 'T+2' settlement means the settlement and delivery of the shares takes place in the 2nd trading day after the trade takes place.

**Secondary market :** A market in which assets are resold and purchased. It operates mainly through stock exchanges. It is that segment of the capital market where the outstanding stocks and securities which have been previously issued are bought and sold. The stock exchange is the secondary market in which financial securities are traded. The secondary market can either be an auction market where trading of securities is done through the stock exchange or a dealer market, popularly known as Over The Counter where trading is done without using the platform of the stock exchange.

**Treasury Bills :** Instruments of short-term borrowing of the government and play a vital role in cash management of the government. Being risk-free, their yields at varied maturities serve as short-term benchmarks and help pricing varied floating rate products in the market.

## 2.8 Exercises

**A. Short-answer type Questions**

1. The money market is different from the capital market. Do You agree ? Give reasons for your answer.

2. What is Badla ? To whom it may be compared ? Do you think that Badla must be banned ?
3. What is primary Market ?
4. What is secondary market ?
5. What is SEBI ? What are the function of SEBI ?

**B. Medium-answer type questions**

1. What is financial repression ? What are its characteristics ?
2. What is meant by money market ? Discuss the significance of money market in a modem economy.
3. Discuss various constituents of money market and their functioning in India.
4. Discuss various characteristics of a developed money market. Can Indian money market be termed as developed money market ?
5. Distinguish between money market and capital market. Highlight the drawbacks of Indian money market which make it an underdeveloped money market.
6. Write the characteristics of Indian money market. Outline the measures to improve the functioning of Indian money market.
7. What are the functions of money market ?
8. Why are capital markets important for economic development of India ?

**C. Long-answer type Questions**

1. List down the major reforms in the Indian money market. Discuss the impact of reforms in the money market.
2. List down the major reforms in the primary and secondary capital market.
3. What were the reform measures to strengthen the Indian money market ?

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# Unit - 3 ❑ Monetary Policy

**Structure**

**3.1 Objectives**

**3.2 Introduction**

**3.3 Objectives of Monetary Policy**

**3.4 The Evolution of Monetary Policy Operating Framework**

**3.5 Globalization of Monetary Policy**

**3.6 Changing Contours of Monetary Policy in India**

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**3.8 Summary**

**3.9 Exercises**

**3.10 References**

## 3.1 Objectives

After reading this unit, you will be able to :

- Understand the objective of monetary policy;
- Examine the evolution of monetary policy operative framework;
- Know how the monetary policy has been globalized;
- know the impact of new industrial policy on industrial growth; and
- state the changing contours of monetary policy in India.

## 3.2 Introduction

In its conduct of monetary policy, the central bank responds to the evolving activity within an articulated monetary policy framework. This framework would normally have three basic constituents, viz., (a) the objectives of monetary policy; (b) the analytics of monetary policy focusing on the transmission mechanism and

(c) the operating procedure, focusing on operating targets and instruments. For the sake of convenience, each of the issues has been dealt with separately along with evolution of monetary policy franework from early date, and in this light, the Indian experience has been touched upon briefly.

## 3.3 Objectives of Monetary Policy

Historically, monetary policy in India has always been part of an overall strategy to ensure the achievement of overall economic objectives such as high rates of growth, fuller employment, price stability, a healthy balance of payments, and social justice in the distribution of income and wealth. Monetary policy instruments have been employed to ensure demand sufficiency and fuller employment while maintaining price stability by ensuring a full use of productive capacity and allowing its sectoral expansion in line with the growth of aggregate and sectoral demands. In this context, monetary policy is interpreted in a broad sense as including not only policies to influence the overall supply of money such as interest rate and reserve policies but also credit policies to influence the sectoral allocation of credit in line with agreed overall economic objectives. Such objectives have been achieved in various ways, including deficit financing of government investments, the regulation of bank investments through primary and secondary reserve requirements and through selective credit controls, and the regulation of interest rates.

## 3.4 The Evolution of Monetary Policy Operating Framework

The concept of monetary policy has evolved since the early 19th century. It played a relatively minor role before 1914, although it was then that many of the tools and principles were developed. The role of monetary policy in stabilizing prices and output came to fruition in the 1920s. From the First World War onwards, central banks focused entirely on public objectives, and many fell under public control. Their objectives also changed towards shielding the domestic economy from external shocks and stabilizing real output and prices. The trend continued in the 1930s but for the Federal Reserve, which used a flawed model—the real bills doctrine—and adhered to a less than credible gold standard, the policy was a recipe for disaster and led to great contraction of 1929–33. The Great Depression led to a major reaction against central banks, which were accused of creating the depression. Virtually in every country monetary policy was placed under the control

of the Treasury and fiscal policy (tax and /or public expenditure policy for purposes of dampening the fluctuations of the economic cycle). In every country central banks followed a low interest peg.

Monetary policy was restored to the central banks in the 1950s and 1960s. But inflation was broken in the early 1980s by concerted tight monetary policies in the United States, the UK and other countries and a new emphasis placed on the importance of low inflation. As a result, goal of independence was conferred on Central Banks to keep inflation low in many countries. Nay, the monetary policy re-emerged as a potent instrument of economic policy in the fight against inflation in the 1980s. Issues relating to the conduct of monetary policy came to the forefront of policy debates. The relative importance of growth and stability as the objective of monetary policy as well as appropriate intermediate target of monetary policy became the focus of attention. Over the years, particularly by the late 1990s, a near-consensus had emerged among the industrially advanced countries that the dominant objective of monetary policy should be price stability. But as regards to the appropriate intermediate target, difference of opinions existed among the central banks.

**Classical Monetary Policy**

The true origin of the modern monetary policy occurred under the classical gold standard, which prevailed from 1880 to 1914. Under the gold standard all countries would define their currencies in terms of a fixed weight of gold and then all fiduciary money would be convertible into gold. The key role of the central bank was to maintain gold convertibility. Central banks were also supposed to use their discount rates to speed up the adjustment to external shocks to the balance of payments, that is, they were supposed to follow the 'rules' of the game. In the case of a balance of payments deficit, gold would tend to flow abroad and reduce central banks' gold reserves. According to the rules, the central banks would raise its discount rate. This would serve to depress aggregate demand and offset the deficit. At the same time the rise in rates would stimulate a capital inflow. Reverse is the case with in case of a surplus.

There is considerable debate on whether the rules were actually followed.There is evidence that central banks sterilized gold flows and prevented the adjustment mechanism.

**The Goals of Monetary Policy**

Until 1914, the dominant monetary regime was the gold standard. Since then, the world has gradually shifted to a fiat money regime Where fiat money consists in a deposit at a bank or a similar institution that can be used together with notes and coins as a medium of exchange (Now with the development of financial innovation there is a continuum of financial instruments which meets this definition). Under the classical gold standard the key goal was gold convertibility with limited focus on domestic economy. By the interwar period convertibility was being overshadowed by emphasis on domestic price level and output stability, and the regime shifted towards fiat money. This continued after the Second World War. Under the 1944 Bretton Woods Articles of agreement, member countries were to maintain pegged exchange rate and central banks were to intervene in the foreign exchange market to do this, but the goal of domestic full employment was also given predominant. The Bretton Woods evolved into a dollar gold exchange standard in which members currencies were convertible on a current account basis into dollar and the dollar was convertible into gold (Bordo, 1993). A continued conflict between the dictates of internal and external balance was a dominant theme from 1959 to 1971 as it was the concern over gold imbalance.

The collapse of Bretton Woods between 1971 and 1973 was brought about largely because the United States followed an inflationary policy to finance both the Vietnam War and expanded social welfare programmes like medicare under P. Johnson's Great Society, thus ending any connection of the monetary regime to gold and propelling the world to a pursue fiat regime and belief that the Phillips Curve trade-off between inflation and unemployment existed : this led to a focus on maintaining full employment at the expense of inflation. In the wake of the demise of the Bretton Woods system in the 1970s, high and volatile inflation, frequent recessions and very volatile output were plaguing the USA and most other industrial countries. For example, US inflation hit 12 per cent in 1975, fell to 5 per cent in 1977 and then increased to 15 per cent in 1979. The standard deviation of real GDP growth was large at 2.8 per cent in the United States and 2.7 per cent on average in the G7. Many observers criticized the performance of policy makers.

The resulting 'great inflation' of the 1970s finally came to an end in the early 1980s by central banks following tight monetary policies. Since then the pendulum has again swung towards the goal of low inflation and the belief that central banks should eschew control of real variables.

**Instruments of Monetary Policy**

The original policy instrument was the use of the discount rate and rediscounting. Open market operations ( the buying and selling of government securities) was first developed in the 1870s and 1880s by the Bank of England in order to make bank rate effective, that is to force financial institutions to borrow. In the interwar period the newly established Federal Reserve initially used the discount rate as its principal tool, but heavy criticism for its use, the Fed shifted to open market policy, its principle tool ever since.

**Intermediate Targets**

Traditionally, central banks altered interest rate as the mechanism to influence aggregate spending, prices and output. In the 1950s, the monetarist revived the Quantity Theory of Money and posited the case for using money supply as the intermediate target. But this process generated the great inflation of the 1970s. By the 1970s most central banks had monetary aggregate targets. However, the rise of inflation in the 1970s as well as continuous financial innovation made the demand for money function less predictable. This meant that central banks had difficulty in meeting their money growth target. In addition the issue was raised as to which monetary aggregate to target. By the late 1980s most countries had abandoned monetary aggregates and returned to interest rates. But since early 1990s monetary policy in many countries had been based on pursuing an inflation target (implicit or explicit) with the policy rate set to allow inflation to hit the target, a policy which seems to be successful.

**Theories of Monetary Policies**

The development of practice of monetary policy described above was embedded in major advances in monetary theory that began in the first quarter of the 19th century. Two principles became embedded in central banking lore — gold standard and the real bill doctrine. Adherence to the two pillars led to disaster in 1930. The depression was spread globally by the fixed exchange rate gold standard. In addition, the gold standard served as 'golden fetters' for most countries because they could not use monetary policy to allay banking panics or stimulate the economy lest it triggers a speculative attack.

The Great Depression gave rise to the Keynesian view that monetary policy was impotent. This led to the dominance of fiscal policy over monetary policy for the next two decades. The return to traditional monetary policy in the 1950s

was influenced by Keynesian monetary theory. According to this approach monetary policy should influence short-term rates. This money market approach dominated policy until the 1960.

Today's central bank, dedicated to low inflation, can be viewed as following the Taylor rule, according to which they set the nominal policy interest rate relative to the natural interest rate as a function of the deviation of inflation forecasts from their targets and real output from its potential. On its way forward, the issue of rules versus discretion came as a key theme in monetary policy.

A more recent approach focuses on the role of time inconsistency. According to this approach, a rule is a credible commitment mechanism that ties the hands of policymakers and prevents them from following time- inconsistent policies — policies that take past policy commitments as given and react to the present circumstances by changing policy. In this vein, today's central bankers place great emphasis on accountability (a central bank's ability to stick to its own policy announcements) and transparency to support the credibility of their commitments to maintain interest rate geared towards low inflation.

## 3.5 Globalization of Monetary Policy

The 1990s and then on has at large witnessed some convergence in the conduct of monetary policy of the central banks throughout the globe. In this vein, there are strikingly similarities or commonalities as evident from cross-country evidence as well as common features in the choice of instruments as well as operating procedures to determine at best the macroeconomic development and the formation of expectations. With globalized financial markets comes increased financial inter dependence. With the progressively increasing globalization of financial markets and emphasis on central bank autonomy, communication strategies, and thereby public accountability are at the forefront in all central banks

Now the question arises inevitably: what are the common features? The answers are not far to seek. In fact, there are several common features. For example, now there is greater coordination and governance between central banks, fiscal authorities, and the regulatory bodies governing financial markets. Central bankers are nowadays are constantly engaged in refining their technical and managerial skills to deal with the complexities of financial markets. Also the cycles of economic activity has

become synchronized across countries. There have been significant shifts, in addition, apart from other factors, in instrument mix, etc.

On the downside, looms large the challenges facing monetary authorities to balance the various choices into a coherent whole and to formulate a policy as an art of the possible across the globe in case of uncertainty that can easily transmit through confidence channel and run the conduct of monetary policy extremely difficult. So consideration of financial stability has a place in this regard.

**Monetary Policy in a Global Environment**

The process of continuous integration in trade, production, and financial markets across countries and economic regions which is what is generally defined as "globalization" - affects directly the conduct of monetary policy in a variety of respects. In terms of monetary policy, there has been much debate about the possible increased role of global factors in the determination of inflation and whether globalization may have weakened the ability of the Reserve Bank of India (RBI) to control the domestic rate of inflation. Overall, the conclusion seems to be that globalization has had effects on inflation in the shorter term. Accordingly, it is necessary to actively monitor possible ongoing changes in the inflationary process resulting from globalization. In particular, macro-prudential financial supervision needs to be strengthened considerably to monitor and help prevent the propagation of systemic risk.

While in the conduct of monetary policy, individual country experiences vary in tune with country-specific diversities, cross-country evidence highlights the fact that there are several common features driving this phenomenon .The important among them are as listed here:

1. Cycles of economic activity have become increasingly synchronized across countries, irrespective of their levels/stages of development.
2. At the macro level, there is now widespread concern about the potential harmful effects of persistently high fiscal deficits as it may lead to excessive monetization.
3. There have been significant shifts in instrument mix. Drastic reductions in statutory preemptions, greater reliance on indirect instruments, emphasis on the flexibility and timing of policy response, and, in general, a greater market orientation, are all major elements of this shift.

4. There is greater activism in liquidity management and a focus on the short end of the market spectrum; this has also been engendered by the growing integration of financial markets, both domestically and internationally.
5. There is greater coordination between central banks, fiscal authorities, and the regulatory bodies governing financial markets.
6. Finally, one direct effect of globalization on monetary policy operations has been to increase the time and attention that policymakers and staff must devote to following and understanding developments in other economies, in the world trading system, and in world capital markets. These developments have been globally associated with a distinct lowering of inflation.

On the downside, the challenges facing monetary authorities have become sharper. The heightened uncertainty surrounding the conduct of monetary policy has made the interpretation of macroeconomic and financial data difficult. Uncertainty is now more easily transmitted across the world through the confidence channel, forcing monetary authorities to contend with the contagion from shocks. Since the 1990s, considerations of financial stabilities have assumed increasing importance in monetary policy throughout the globe.

**The Indian Experience**

In reality, while there are growing tendencies toward globalization, the conduct of monetary policy depends on a number of factors that are unique to a country and to the context. Given the policy goals, the contours of monetary policy are shaped by the macroeconomic structure of the economy and its institutional setting. Other important factors that play a decisive role are the degree of openness (or the trade orientation ratio) of the economy, the stage of development of financial markets, payment and settlement systems, and the technological infrastructure.

Against this backdrop, turning to the specific features of the monetary policy in India, one may note the following features :

(i) While there is no explicit mandate for price stability, the conduct of monetary policy has evolved around the objectives of maintaining price stability and ensuring an adequate flow of credit to the productive sectors of the economy to sustain the overall economic growth. The relative emphasis on price stability and growth depends on the underlining macroeconomic conditions. However, the democratic processes in India work in favour of price stability.

(ii) The financial environment, certainly, in which Indian monetary policy is made has been irrevocably changed by the remarkable increases in the magnitudes of financial flows into and out of the India. The transition to a multiple indicator approach wherein, besides monetary aggregates, information pertaining to a range of rates of return in different financial market segments along with the movements in currency, credit, the fiscal position, merchandize trade, capital flows, the inflation rate, the exchange rate, refinancing, and transactions in foreign exchange - has been a logical outcome of monetary policy reforms.

(iii) Liquidity management is carried out through open market operation (OMO) in the form of outright purchases/sales of government securities and reverse repo (an instrument for borrowing funds for a short period and involves selling them as a stated future rate for a slightly higher price/ repo operations). Over the years, in comparison with other monetary policy instruments, the use of interest rate instruments (repo and reverse repo) by RBI has been more frequent.

(iv) Notwith standing the concerted reforms undertaken since the 1990s, for example, freeing monetary policy from the burden of automatic monetization and a significant marketization of the government's borrowing program, monetary policy in India continues to be constrained by fiscal dominance. Debt-management considerations to ensure a smooth passage of the borrowing program of the government, at minimum costs and roll over risks, make the overall monetary management difficult when large and growing borrowing year after year puts pressure on the absorptive capacity of the market and on liquidity management. In this context, the FRBM, which envisages a vacation of primary financing of the fiscal deficit by the RBI from 2006 to 2007, enhances the flexibility of monetary management.

(v) The predominance of publicly owned financial intermediaries has its implications for monetary policy. Crossholdings and interrelationships in the financial sector emphasized in planned development were to achieve the social goals of the "joint family" headed by the government. With the needs and consistent of a market economy, these are being gradually revamped.

(vi) Monetary management in India is somewhat constrained by the lack of comprehensive and timely information in some areas relative to the demands

of a fast-growing and increasingly globalizing economy. One lacuna is the absence of credible data on the labor market. Employment data essentially pertain to the organized sector, which constitutes less than 10% of the total labor force.

(vii) The financial system in India has a relatively low vulnerability to asset bubbles. There is limited exposure of bank lending to the sensitive sectors, including real estate. While the demand for housing is strong, the overall exposure is moderated by assigning higher risk weights to housing loans than required under the Basel norm.

The monetary policy has been successful in ensuring financial stability when frequent financial crises led to debilitating losses in growth and welfare in large parts of the developing world. It is useful to note that the RBI has been engaged in the development of sound and efficient financial intermediaries and markets so as to set solid foundation for the effective transmission of the monetary policy through channels of money supply and credit, the interest rate channel, and the exchange rate channel, asset price channel, and expectation channel. In this context, it becomes necessary to touch upon what is called as the "impossible trinity," or the "trilemma of monetary policy." The basic message of the trilemma is that a central bank can achieve any two of the following parameters, but not all three: fixed exchange rate, open capital account, and independence monetary policy. The combination of managed flexibility and partial capital account controls has allowed India to resolve, to a great extent, the trilemma of the famed "Impossible Trinity." With the help of partial capital controls India has successfully enjoyed substantial monetary independence and a fair degree of exchange rate flexibility.

## 3.6 Changing Contours of Monetary Policy in India

In the first three decades after India's Independence, fulfillment of plan targets was the dominant objective of the government of India. And all policy instruments including monetary policy were geared towards that goal. The Reserve Bank of India (RBI) as the Central Bank of India expanded the financial infrastructure by creating several new instruments and allotted credit in tune with the plan priorities. Though the RBI played a major role in this period, it ought to abide by the guideline of the government. And so long as inflation was moderate, this approach worked well. But in keeping abreast of the world-wide inflation broken in the early 1970s

and continued to the whole decade by the whirl of tight monetary policy in the United States, the UK and other countries, India only saw inflation at that period and it, in the 1970s, touched unacceptable levels and as a result, growth of the money supply had to be tamed and reigned in.

A continuous 'battle' between the RBI and the Ministry of Finance on the control of inflation and the need to contain fiscal deficit came to the fore in the 1980s.The period was marked by uneven growth though accompanied by even an average growth of little over 5 per cent. The average inflation was close to 7 per cent. The annual M3 growth was 17 per cent. In 1983, the RBI appointed a Committee to review the working of the Indian Monetary System. Submitting its report in 1985, the Chakravarty Committee recommended that in a need to regulate the money supply, the money supply growth ought to be consistent with real growth and acceptable level of inflation. Interestingly, the Committee regarded tolerable rise in prices at 4 per cent. This, according to the Committee, will reflect changes in relative prices necessary to attract resources to growth sectors. It also stressed for close co-ordination between monetary policy and fiscal policy. Thus Committee's vision converted into a scheme what came to be described as flexible monetary targeting. But in the latter of the 1980s the Indian economy still saw a higher fiscal deficit and higher money supply growth, in spite of the acceptance of the recommendations. All these propelled Indian economy to dip into the crisis of 1991.

In the wake of the economic crisis in 1991 triggered by a difficult balance of payments situation, the Government introduced far reaching changes in India's economic policy. Monetary policy was used effectively to overcome the balance of payments crisis and promptly restore stability. An extremely tight monetary policy was put in place to reap the full benefits of the devaluation of the rupee that was announced. However, it did not stop with that. Financial sector reforms became an integral part of the new reform programme. Reform of the banking sector and capital market was intended to help and accelerate the growth of the real sector. Banking sector reforms covered a wide gamut. The most important of the reforms was the prescription of prudential norms including capital-adequacy ratio. In addition, certain key changes were made with respect to monetary policy environment which gave commercial banks greater autonomy in relation to the management of their liabilities and assets. First and foremost, the administered structure of interest rates was dismantled step by step. Banks in India today enjoy full freedom to prescribe the deposit rates and interest rates on loans except in the case of very small loans

and export credit. Second, the government began borrowing at market rates of interest. The auction system was introduced both in relation to Treasury Bills and dated securities. Third, with the economic reforms emphasizing a reduction in fiscal deficit, pre-emption in the form of CRR (Cash Reserve Ratio) and SLR (Statutory Liquidity Ratio) were steadily brought down (Table 1). Fourth, while the allocation of credit for the priority sector credit continued, the extent of cross subsidization in terms of interest rates was considerably brought down because of the reform of the interest rate structure.

The 1990s saw a sea change in the contour of monetary policy. For example, (i) the system of ad-hoc Treasury Bills under which Government of India could replenish its cash balances by issuing a Treasury Bills in favour of the RBI and which had the effect of monetizing deficit was phased out. It was replaced by a system of Ways and Means Advances which had a fixed ceiling. As a result, the automatic monetization of fiscal deficit came to an end; (ii) Besides, by moving to market–determined rate of interest, government securities became marketable and it has enabled the emergence of open market operations as an instrument of credit control. The dismantling of the administered structure of interest rate enabled the rate of interest to emerge as a policy variable. 'Repo' and 'reverse repo' operations emerged for the first time as an instruments of monetary control; (iii) The Liquidity Adjustment Facility introduced for the first time in 1999 and refined later has emerged as a principal operative instrument to manage market liquidity on a daily basis. Bank rate acquired a new role in the changed scenario.

During 1993 and 1994, for the first time monetary policy had to deal with the monetary impact of capital flows with the forex reserve increasing sharply. In 1995-96, central bank witnessed a new experience in the field of stability of the exchange rate of the rupee vis-à-vis the US dollar.

Post-1997 was earmarked by a series of approaches of multiple indicators. For example, the Liquidity Adjustment Facility (LAF) introduced first in 1999 and refined later emerged as a principal operative instrument to manage market liquidity on a daily basis. Under a fully functioning LAF the RBI would have repo and reverse repo rates which could be altered as and when necessary. Bank Rate acquired a new role in the changed context. So too the repo and reverse repo rates. The Nineties have paved the way for the emergence of monetary policy as an independent instrument of economic policy. But the issue connected with multiple objectives

such as to (i) maintain a reasonable degree of price stability and (ii) to help accelerating the rate of economic growth remained the same.

In the years before and after the 2008 global crisis, RBI focused on financial stability that applies to both institutions and markets and that implies ability of the institutions to meet their obligations on their own without interruption or outside assistance. And markets are said to be stable when prices in financial markets are not volatile and participants can confidently transact in them at prices that reflect fundamental forces. In 2016, RBI moved to a new monetary policy framework—a sophisticated strategy—which may be described as one of flexible inflation targeting (it does not target the current rate of inflation, but the bank's own inflation forecasts) as the central-piece of its monetary policy. This strategy was also adopted by some 28 central banks after 1990 with the expectation that it ensures a high degree of transparency and predictability of monetary policy and it is always forward –looking and here Rule–based policy and the discretionary policy are well combined. The interest rate (Repo Rate) in the Indian context became the operating target. Moving to the new policy framework, clarified the objective of monetary policy. But RBI has to contend with many other issues with respect to monetary policy. The question of when to raise or lower the interest rate will always be a contentious issue.

Changes in the exchange rate and foreign trade regimes have added an additional dimension to India's monetary policy. External considerations have now to be taken into account in the conduct of monetary policy. There have been years in which the Reserve Bank had to fight the impact of capital outflows and there have also been years in which the major concern is how to deal with the large capital inflows. With large capital inflows there can be unsustainable appreciation of rupee and when the market assessment is that the appreciation is unsustainable, there can be sudden outflows and an uncontrollable spiral of depreciation of the currency.

**Recent Phenomenon :** Given the unprecedented shock of COVID-19 pandemic, monetary policy was significantly eased from March 2020 onwards. The repo rate has been cut by 115 bps since March 2020, with 75 bps cut in first Monetary Policy Committee (MPC) meeting in March 2020 and 40 bps cut in second meeting in May 2020. The policy rates were kept unchanged in further meetings, but the liquidity support was significantly enhanced. Systemic liquidity in 2020-21 remained in surplus so far. RBI undertook various conventional and unconventional measures like Open Market Operations, Long Term Repo Operations, Targeted Long Term Repo Operations etc. to manage liquidity situation in the economy.

## 3.7 Conclusion

The mandate of the central bank has now become wider all over the world. In that sense, the contours of monetary policy are changing. This is inevitable with the increasing complexity of the system in which central banks operate. However, to deal with other objectives such as financial stability, standard instruments of monetary policy will not be adequate. Regulation and supervision combined with an appropriate monetary stance will be necessary to maintain financial stability. In particular, micro-prudential regulation and macro-prudential financial supervision needs to the strengthened considerably to monitor and help prevent the propagation of systemic risk. Total discretion with respect to objectives will make monetary policy indeterminate. Central banks need to be transparent and explicit with respect to objectives. What is needed is a good combination of rules and discretion. Among the various objectives such as price stability, growth, and financial stability, the dominant objective for central banks particularly in emerging market economies like India must be price stability. Having an inflation target helps in this regard. Under such a situation, inflation expectations get truly anchored. In ordinary circumstances, by maintaining price stability a central bank can pave the way for the fulfillment of other objectives as well over the medium term. However, extraordinary circumstances will warrant extraordinary responses. Successful central banks are those which respond to problems with speed, tact and intelligence.

## 3.8 Summary

**Financial stability :** It is difficult to define the term "financial stability". There is no universally accepted definition. The term 'stability' or 'instability' refers to the behaviour of the system rather than to individual institutions. However, one cannot rule out that failure of a single financial institution can trigger significant financial turmoil. Stability requires (i) the key institutions in the financial system are stable, in that there is a high degree of confidence that they can continue to meet their contractual obligations without interruption or outside assistance, and (ii) that the key markets are stable in that participants can confidently transact in them at prices that reflect fundamental forces and that do not vary substantially over short periods when there have been no changes in fundamentals. On the other hand, instability implies inability of institutions to meet their obligations on their

own. Markets are said to be unstable when prices in financial markets are volatile and moved by amounts not justified by changes in fundamentals. Like unstable equilibrium, instability implies inability to correct itself on its own. Instability, if it persists, turns into a crisis.

**Flexible Inflation targeting :** In 2016, RBI moved to a new monetary policy framework—a sophisticated strategy—which may be described as one of flexible inflation targeting (it does not target the current rate of inflation, but the bank's own inflation forecasts) and it used as the central-piece of its monetary policy. This strategy was also adopted by some 28 central banks after 1990 with the expectation that it will ensures a high degree of transparency and predictability of monetary policy and it is always forward–looking and here Rule–based policy and the discretionary policy are well combined. Still it may be dangerous. In case of India, inflation in India can arise from a variety of causes, and it is important to know what the appropriate monetary instruments are for each case. Use of inappropriate monetary instruments can do more harm than good, and limiting the monetary authority's instruments to a single primary one can be dangerous. RBI can certainly be proud of finally achieved a "state-of-the-art" monetary framework.

**Globalization of monetary policy :** The period since the 1980s has witnessed some convergences in the conduct of monetary policy worldwide. Currently, there are striking similarities in the tools that monetary authorities employ to assess macroeconomic developments and the formation of expectations. In the choice of instruments as well as operating procedures, there are common features.

**Impossible Trinity, or the Trilemma of monetary policy :** This refers to the incompatibility between three policy choices, viz., (a) fixed exchange rate; (b) open capital account and (c) independent monetary policy The basic nessage of the trilemma is that a central bank can achieve any two of the above-mentioned parameters, but not all three. That is, if a country wants to have a fixed exchange rate and an independent monetary policy, it is difficult to main an open capital account.

## 3.9 Exercises

**A. Short-answer type Questions**

1. What is monetary policy ?

2. What is impossible trinity ? Why is it called so ? How did India resolve the impossible trinity ?
3. What are the objectives of monetary policy ?
4. What were the original policy instruments of monetary policy ?
5. What is financial stability ?

**B. Medium-answer type questions**

1. Do you agree with the statement that the true origin of the modern monetary policy occurred under the classical gold standard, which prevailed from 1880 to 1914. Give reasons for your answer.
2. What role does Central Bank play for achieving financial stability?
3. State the monetary policy of the RBI in situation of COVID-19 Pandemic.
4. Do monetary transmission mechanisms work in India?
5. What type of monetary policy was introduced when India was in deep trouble following the BoP crisis in 1991.
6. Do you think that RBI's policy on inflation targeting will do well to the Indian economy? Give reason.
7. "The monetary policy has been successful in ensuring financial stability in India though two decades when frequent financial crises led to debilitating losses in growth and welfare in large parts of the developing world." In the light of the above statement, define financial stability and financial instability. Is the statement correct?

**C. Long-answer type Questions**

1. How the contours of monetary policy are changing over the years?
2. How has the concept of monetary policy evolved since the early 1990s.
3. Explain the post-1997 monetary policy of the RBI?
4. Do you think that the 1990s saw a sea change in the contour of monetary policy in India. Give reasons.
5. Write a note on the globalization of monetary policy and the Indian experience.

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# Unit - 4 ❑ India's External Sector

**Structure**


**4.1 Objectives**

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**4.3.1 Import Substitution Industrialization**

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## 4.1 Objectives

After going through this Unit 4, you will be able to

- Have a general overview of India's external sector;
- Get contours of external sector reforms;
- Examine the Impact of WTO on India's economy;
- Learn about India's Trade balance and BoP position in recent years; and
- Have a general knowledge about the impact of capital inflows on the Indian economy

- Also have the general ideas related to forex reserves

## 4.2 Introduction

Policy of foreign trade and investment are both crucial in the development process. On the imports side, foreign trade is helpful in getting technology, managerial expertise and intermediates essential for growth of the economy. To sustain such imports, exports too need to expand to help finance the imports needed for a high growth path and diversification of the economy. Else, a trade imbalance would induce disruption in the supply of imports causing adverse repercussions for the whole economy. Hence, the foremost concern in trade policy is to promote exports in order that there is no difficulty in financing the imports needed for the growth of the economy.

There are many means like institutional innovation, organizational restructuring and policy initiatives which helps attain the desired long run objectives of foreign trade. Among these, policy has a primacy because if policy initiatives are not properly tuned, it transmits an inappropriate set of signals to domestic producers. This equally applies to the Foreign Direct Investment (FDI) as also the Foreign Portfolio Investment (FPI) [or the FII i.e. the Foreign Institutional Investment] policies. Against this background, the present unit begins by making a distinction between the policies of import substitution and export-led growth strategies. Thereafter, it proceeds to explain the foreign trade policy pursued in India prior to 1991 and post–1991 and the FDI and FII policies pursued so far in India.

## 4.3 General overview

For an economy, foreign trade consists of inward and outward movement of goods and services, resulting in inward and outward flow of foreign exchange from one country to another. In present times, international trade policy is a vital part of development strategy. It can be used an effective instrument of economic growth, employment generation and poverty alleviation for an economy.

### 4.3.1 Import Substitution Industrialization

Import Substitution industrialization (ISI) is a trade policy based on the premise that a developing country should attempt to substitute products it imports with

domestically produced substitutes. It is also based on the premise that a country attempt to reduce its foreign dependence through the local productionof industrial goods. It is an economic development strategy that was in wide use from the end of the World War II through the mid 1960s. At its zenith in the 1960s, it was adopted by developing countries in Africa, Asia and especially Latin America. The approach was guided by the Prebisch-Singer hypothesis which states that the 'price of primary commodities, relative to the price of manufactured goods, declines over the long term causing the ToT (terms of trade) of primary product based economies to deteriorate'. To avoid this, many developing countries including India embraced the ISI policy. The ISI has three major tenets or principles viz. (i) an active industrial policy to promote a domestic industrial base (while this is good in itself, the domestic industries tend to grow accustomed to protection from foreign competition with no incentive to become more efficient which makes the tenet to work adversely for the country adopting the ISI strategy); (ii) protective barriers to trade (e.g. tariffs and quotas placed to protect domestic infant industries tend to keep the domestic units uncompetitive and inefficient); and (iii) a monetary policy that rations foreign exchange by multiple exchange rates so as to channel the imports of intermediate capital goods (i.e. imports are made difficult or expensive discouraging the process of importing).

In India, the state-backed import substitution became the thrust of the trade policy in the late 1950s. Conceived mainly as a long-term solution to India's BoP difficulties, the short-term problems were sought to be taken care of by a tight system of import controls as well as by arranging for a large-scale inflow of assistance. Protection to promote domestic industries through high tariff barriers, multiple exchange rates, import licensing arrangements and subsidies was thus not seen as detrimental to trade and development. The import substitution regime continued till 1981. Such prolonged use of ISI policy in India is since recognized to have resulted in market concentration, high unit cost of production, overvaluation of currency, extreme government intervention in production, etc. cumulatively contributing to an anti-export bias. Thus, the ISI strategy yielded neither industrialisation nor growth with the long term growth from the late 1950s to 1981 having remained an average 3.5 percent per annum. It is only in the post-1980s, with the adoption of ELG strategy that the economy started growing at a faster long term average annual growth rate of 5.5 percent successively till the later years of 1990s when the growth rate peaked to cross the 7 percent mark.

### 4.3.2 Export-Led Growth

Export–led growth (ELG) is an economic development strategy emphasizing on the exploitation of a country's actual or potential comparative advantage in production for foreign markets. In other words, ELG is a trade and economic policy, opposite to the ISI policy, aiming to speed up the industrialization process of a country by promoting export of goods for which the nation has a comparative advantage. It is contrasted with the ISI policy since it is 'outward looking' whereas ISI is 'inward looking'. Modern forms of export-led growth strategy first came to prominence in the 1960s when several East Asian countries turned away from the ISI approach and began to promote export of manufactured goods. The success of these Asian export economies, who came to be identified as the Little Dragons or Four Tigers, questioned the idea of export pessimism i.e. the belief that low and middle income developing economies could not compete with manufactured goods in developed country markets. With this, by the mid-to-late 1980s, the strategy of export-led growth had completely replaced the ISI orthodoxy.

In addition to the demonstration effect of East Asian export economies, several other factors stood behind the success of ELG strategy as a policy idea. Prominent among them are: (i) the loss of confidence in interventionist, state-led management of the economy; (ii) the failure of traditional ISI policies to address the worsening economic conditions of Latin America (stemming from its debt crisis of the 1980s); and (iii) the communication and transportation revolution of the last decades of the twentieth century. In particular, the technological changes in transport and communications enabled firms to locate the production units abroad and increased the opportunities for developing countries to participate in production processes spanning across nations. In the case of India, the prolonged import substitution was in terms of high effective rates of protection, market concentration, high unit cost of production and overvaluation of currencies eventually have led to anti-export bias. All these changes supported the idea of pursuing the comparative advantage and ELG as engines of growth.

India initiated its export-led growth strategy in the early 1990s when its economy was begun to be integrated with the world economy. As a result, India's merchandise exports share in world exports increased from 0.5 percent in 1990 to 1.7 percent in 2013. Although this is a meagre increase compared to the corresponding jump achieved by many other competing economies, over the years, the trade policy of India has undergone fundamental shifts to correct the earlier

anti-export bias through the removal of various quantitative restrictions (QRs), reduction and rationalization of tariffs, liberalization in the trade and payment regime, adoption of various export incentive measures, movement toward markets based exchange rates, etc. These measures indicate that the country has seriously opted for ELG strategy so as to improve the competitiveness of Indian products in the global market.

## 4.4 Contours of External Sector Reforms

**External Sector Reforms Prior to 1991 Economic Reform**

Prior to 1991, India had followed a state-backed inward-looking, ISI trade policy with a plethora of controls and regulations in the form of open general licensing (OGL), canalized imports (i.e., monopoly rights of the government for imports), exports incentives through Replenishment Licenses or (RLP), Advance Licenses and Duty Exemption Scheme, Export Processing Zones (EPZs) for free trade environment, Subsidies on Domestic Raw Materials, Fiscal Concessions for Exports, Export Credit and Assistance to Export Promotion Councils (EPCs) and Blanket Exchange Permit Scheme, till 1991. Besides, one of the characteristic elements in the pre-reform period trade policy was that the exchange rate remained overvalued most of the time. Exchange rate adjustment was never used as an instrument to manage the repeated crises of BoP. This made imports cheaper and exports unprofitable further contributing to current account imbalance to Bop.

The gradual liberalization of the 1980s led to some major macroeconomic imbalances. While import liberalization led to a gradual increase in import intensity during the second half of the 1980s, exports did not grow commensurately. Current account deficit (CAD) of BoP soared to an alarming level. Along with high CAD, fiscal deficit also became very high during this period. These factors made India vulnerable to external shock. The authorities then realized that there should be sea change in India's trade policy.

**External Sector Reforms after 1991**

External sector reforms have been the most successful of all the reforms that were undertaken in the 1990s, proving that a well-regulated market-based foreign trade and payments system would be more efficient and equally stable. The strength of the external account rests substantially on the flexibility of the 'managed float'.

The external sector reforms since 1991 have consisted of : (i) Devaluation of the Rupee (i) Abolition of import licensing (ii). Significant reductions in tariff rates and their dispersion (ii) Phased removal of QRs on imports and liberalization of restrictions on capital inflows and FDI. These reforms were not introduced as a package in one go. But the most important change introduced was a switch to a market driven exchange rate regime, abandoning the legacy of an overvalued pegged regime. To smooth the transition, in March 1992, a liberalized exchange rate management system (LERMS) was introduced. Since 1993 the rupee has been convertible for current account transactions (i.e., convertibility under Article VIII of IMF). However the present exchange rate continues to be, at best, managed (or dirty) float.

Both import and export trade grew rapidly in the 1990s in response to these changes. Since then as part of its commitments as a member of the WTO India has removed remaining quota barriers to trade, set maximum bound tariff rates and lowered overall protection. It is now a much more open economy than in previous decades (total foreign trade was 45 per cent of GDP in 2007 as compared with only 16 per cent in 1990), although its average level of protection is still relatively high by current standards of WTO members.

Dismantling of the trade control system only commenced seriously in 1991 in response to a major crisis in the balance of payments and the need for India to seek IMF financial assistance to meet international debt obligations. Licensing for the import of most capital and intermediate goods was removed and most goods saw their import tariffs (i.e. their nominal protection) lowered substantially. The share of imports subject to quantitative restrictions fell from nearly 85 per cent in the late 1980s to 54 per cent in 1992-93 and 46 per cent in 1997-98. 4 Average import tariffs fell from 80 per cent in 1990 to around 30 per cent in 1997-98.

As part of the reform package, the Indian Rupee was made convertible against other currencies and devalued significantly against the dollar, whilst at roughly the same time restrictions on investment by foreign firms in Indian manufacturing were eased. Both import and export trade grew rapidly in the 1990s in response to these changes. Since then as part of its commitments as a member of the WTO India has removed remaining quota barriers to trade, set maximum bound tariff rates and lowered overall protection. It is now a much more open economy than in previous decades (total foreign trade was 45 per cent of GDP in 2007 as compared with only 16 per cent in 1990), although its average level of protection is still relatively high by current standards of WTO members.

Overall, in 2006-07, the average tariff on imports to India from other WTO countries was around 15 per cent (as compared with 32 per cent in 2001—02) although when additional specific taxes are taken into account the average rise to nearly 18 per cent. This average masks a number of significant differences. Agriculture receives far more protection than manufacturing and a wide range of exemptions are allowed which means taxes collected as a share of import revenue are often well below the published tariff rates. Within manufacturing two areas — automobiles and textiles and clothing — remain relatively highly protected. In 2006-07, in the former, the average applied tariff was around 33 per cent and in the latter 22 per cent, compared with a manufacturing average of around 15 per cent. As further protection, imports of second-hand motor vehicles over three years of age are subject to licensing restrictions as well as a 100 per cent import tariff. In other important sectors there has been a rapid reduction of protection; for example, in steel average applied tariffs fell from over 33 per cent in 2001-02 to 7 per cent in 2006-07, although a higher rate of 20 per cent applies to imports of cheaper, low-quality, defective steel products or 'seconds'.

After the wake-up call of economic reforms and trade liberalization, the role of external sector became crucial in determining the fate of Indian economy. Trade balance; exports-imports (X-M) remained negative and sharp even in the post reforms period.

**TRADE POLICY : POST-1991**

In June 1991, India was the most autarkic (that is, with little foreign trade) country in the world. Then came economic reforms in different sectors. The key objective of the post-1991 trade policy reforms was to move to a more open trade regime by correcting for the anti-export basis and to have more export earning, and thereby augmenting aggregate employment. Moreover, there was a greater recognition of the need to view trade policies, exchange rate policies and industrial policies in an integrated manner. In pursuance of this, the administered exchanged rate regime gave way to a flexible market-determined system. The exchange rate has since been guided by underlying demand and supply conditions and the broad principles of careful monitoring and management of exchange rates with flexibility, that is to say, India adopted managed float exchange rate system.

1. **Trade Policy of 1991**

   After devaluation of the Indian Rupee by about 20 per cent many important widespread changes in India's trade policy in July 1991occured. The trade

policy reforms comprised withdrawal of the quantitative restrictions (QRs) or quotas on exports and imports, phasing out of the system of import licensing and lowering the level and dispersion of nominal tariffs so as to bring them on par with the East Asian economies. The peak customs tariff rate was progressively brought down.

There were many more trade policies after 1991 which may be highlighted

**2. 1992-97 EXIM (Export-Import) Policy of 1992-97**

The wave of liberalism continued in 1992-93.. On March 30, 1994, the government made some changes in EXIM Policy of 1992-97 where imports had been liberalized further and adequate incentives were given to boost exports. The rupee exchange rate was made market determined .and the Rupee in August 1994 was made convertible on current account; this meant that restrictions relating to purchase of and sale for current transactions were removed. Import tariffs were further reduced and the average tariff rate in 1993-94 was around 85 per cent.

The next big thing that happened to India's trade regime was the establishment of the WTO in January 1995. India was the founder member of the WTO and had to undertake certain commitments as part of its membership agreement. The structural adjustment loan of the IMF and membership of the WTO marked the end of inward-looking policies for India. Henceforth, Indian government's trade and other policies would have to take into account the commitments and obligations (constraints imposed by the WTO) made to the WTO. A new phase began in India's trade policy. The result was that exports during this period surged ahead and forex reserve rose to a comfortable level.

**3. EXIM Policy of 1997-2002 :**

The main objectives were similar to earlier policies but with some cosmetic changes. For example, restrictions of import of 542 commodities had been removed A total of 894 items were added to the free list of imports. Besides, greater weightage to agro-exports had been given.

**4. Annual Supplements to the 1997-2002 EXIM Policy were made in 2000-01:**

The Special Economic Zones (SEZs) Policy was introduced for the first

time in India in April 2000, as a part of the EXIM policy of India. The basic rationale for the creation of SEZs units is to provide a totally free atmosphere conducive to exports Such units would be allowed to import capital goods and raw materials duty free.

5. **EXIM Policy 2001-02**

This policy removed QRs on the balance 715 items. Thus, in line with India's commitment to the WTO, QRs on all import of manufactured consumer goods and agricultural products were finally removed on April 1, 2001 almost exactly ten years after the reforms began.

Agricultural exports were emphasized for its promotion through designated state trading agencies.

6. **EXIM Policy of 2002-07**

The main thrust of the this policy was to create an expanding base of tradable goods and services SEZs were being set up to further boost the exports. A comprehensive package for development of SEZs was made. The policy was geared towards the goal of attaining US $ 80 billion exports over the Tenth FYP by 2007.

7. **Foreign Trade Policy of 2004-09**

This policy had been renamed as the Foreign Trade policy (FTP) instead of EXIM policy since it takes into account an integrated approach to the development requirement of India's foreign trade.

The twin objectives of the 2004-09 FTP were — doubling India's share in global merchandise trade. For this purpose, in order to boost exports, a new scheme, known as 'Target Plus' was introduced alongside with other schemes like 'Visesh Krishi and Gram Udyog Yojana by encouraging export of village and cottage industry. Besides, 'Served from India Scheme' was built as a brand.

8. **Some Modifications and Annual Supplement to the 2004-09 FTP :**

This was made in April 2007. Here some new features were added to the 'Served from India Scheme.' A major development related to FTP was the operationalisation of SEZ Act, 2005. This FTP has announced some sort of procedural simplification like a single application of "AYAT-Niryat" that helped to reduce paper work by 60 per cent for the exporters.FTP measures include also reduction in peak rate of custom duties to 10 per cent.

All the above policy measures announced in FTP 2004-09 and the Annual Supplement helped India's merchandise exports to grow at more than 20 per cent in the first ninth month of the fiscal year 2007-08.

**9. FTP of 2008-09 :**

Trade policy measures announced by the GoI and the RBI in 2008-09 was to mitigate the effects of global recession. Three stimulus packages by the RBI (like increase in liquidity to the bank for improving credit flows, increases in forex liquidity, easing of credit terms) were given in the second half of 2008-09 to help export sector in general and some sectors affected or likely to be affected by the global recession in particular.

**10. FTP of 2009-14**

In view of this global crisis, many countries adopted some protective measures which hurt India's exports rather badly. Against this economic downturn, unveiled a new FTP on August, 2009.

The immediate objective is to arrest and reverse the downturn slide of India's exports and provide necessary support to the exporters which had been hurt by the recession. The FTP 2004-09 aimed at achieving an annual growth of 15 per cent with annual export target of US $200 billion by March 2011.

**11. FTP 2015-20**

The new FTP 2015-20 includes various new initiatives, provisions and procedures to provide better condition and ease in foreign trade. It sets the objective to achieve or increase the annual level of the country's export to 900 billon dollar by 2020. For this purpose, this new policy introduces new schemes, namely Merchandise Exports from India Scheme (MEIS) for exports of specified goods to specified markets, and Services Export from India Scheme (SEIS). It is indeed commendable that this new FTP brings State and Union Territories for the first time in the process of international trade.

**FDI POLICY**

FDI flows come as capital bundled with technology, skills, and sometimes even market access. They are, therefore, perceived as important resources for expediting the industrial development of recipient countries. Most developing countries, therefore, have a welcoming attitude towards MNCs and FDI since it fosters growth by

increasing capital accumulation, technological change, efficiency, BoP improvement, increase of exports, increase in the overall total amount of investment in the domestic economy, improved access to world markets, help in release of resource constraints on investment, etc. India's FDI policy has so far gone through three main phases as outlined below.

**A. First Phase (1950-1980)**

During this phase, India was receptive to foreign capital, particularly foreign direct investment (FDI). This is indicated in the assurance made by the government in 1949 by stating that: (i) there shall be no discrimination between Indian and foreign undertakings; (ii) facilities will be given to foreign investors for remittances of profit; and (iii) due compensation will be paid in case a foreign undertaking is nationalized.The attitude towards foreign capital remained unchanged in the 1956 Industrial Policy Resolution (IPR). Foreign Investment policy in this phase was largely determined by the struggle between the government and monopoly foreign interests, particularly TNC oil companies.

**B. Second Phase (1980-91)**

The period saw the initiation of liberalisation process and was guided by the principle of relaxation of controls which acted as constraints. The approach to industrial policy saw the deli -censing of industries and the scrapping of the 1969 MRTP Act. However, liberalisation in this period was restricted to limited foreign collaboration. The industrial policy statement of 1977 particularly discouraged foreign collaboration by stating that the inflow of technology would be allowed only in sophisticated and high priority areas where Indian technology had not adequately developed. In areas where foreign technology was not further needed, renewal of foreign collaborations was discouraged.

**C. Third Phase (Post 1991)**

With the announcement of new Industrial Policy of 1991, a new phase in FDI began. After following a restricted FDI policy for more than four decades since Independence, India liberalised its FDI policy considerably. Besides opening new sectors (e.g. banking, mining, insurance telecommunications) to FDI and dismantling of controls and regulations, the government allowed huge concessions and relaxations. In particular, the main measures announced since 1991 to give a boost to FDI are as follows.

(a) Many industries were deregulated and opened to FDI. The Foreign Investment Promotion Board (FIPB) was allowed to sanction 100 percent equity participation in cases where Indian companies were unable to raise funds.

(b) Procedures for obtaining permission were simplified by listing industries eligible for automatic approval up to specified levels of foreign equity. For instance, 51 percent foreign equity was permitted with automatic approval in industries producing intermediate and capital goods;

(c) Besides FDI, portfolio equity investment (PEI) from abroad was also given an impetus. Under this, foreign institutional investors were allowed to purchase shares of listed Indian companies in the stock market thereby opening a window for portfolio investment in existing companies. Thus FIIs were allowed to operate in the Indian capital market and Indian companies were allowed to raise capital in the international market. These policy changes have led to a significant increase in FDI flows from negligible levels in 1990 to 1% of GDP per year during the 1990s. Between 1993-94 and the end of the decade, India attracted about $22 billion in portfolio investment and more than $ 18 billion in FDI.

While the above measures are of the period 1991-95, in post-1995 a series of more liberalizing measures were taken. These are :

(a) Introduction of dual route of approval of FDI i.e. RBI's automatic route and the FIPB route;

(b) Automatic permission for technology agreements in high priority industries;

(c) Removal of restriction of FDI in low technology areas and liberalisation of technology imports;

(d) Permission to NRIs and overseas corporate bodies to invest up to 100 percent in high priority sectors;

(e) Hike in foreign equity participation limits to 51 percent for existing companies;

(f) Foreign equity participation for up to 100 percent for projects relating to electricity generation, transmission and distribution, and roads and highways, etc.;

(g) Increasing the ceiling for FDI in oil refining from 49 percent to 100 percent;

(h) 100 percent FDI in telecommunication sector, tea sector, airports, etc.

In more recent years (2014), an investor-friendly FDI policy to permit FDI of up to 100 percent under the automatic route in most sectors/activities (e.g. construction, operation, and maintenance of identified railway transport infrastructure) except in defence where FDI cap is kept at 49 percent is implemented. Norms related to minimum land area, capitalisation, and repatriation of funds for FDI in construction development projects have been further liberalized. However, in some sectors FDI is completely banned. These are: retail trading (except in single-brand wholesale trading), atomic energy, lottery, real estate business, chit fund business, cigarette manufacturing, etc. In 2016, the government allowed 100 percent FDI for marketplace e-commerce. During this period, FDI in the pension sector has been revised to permit foreign investment up to 49 percent, with 26 percent under automatic route.

In sum, Policies with regard to FDI have been liberalized substantially since 1991. Measures adopted ranged from opening new areas to FDI and raising equity participation limits across a wide limits across a wide spectrum of activities to bringing several sectors under the automatic approval route o the RBI.

**Results from reforms :**

The result from this FDI policy is that FDI as a percentage of gross domestic investment (GDI) and GDP has grown rapidly between 1991-92 and 2015-16. Despite this expansion, FDI inflows to India are low compared to other countries of Asia. Ironically, despite the investment-friendly liberal FDI regime, India is ranked 'fourth' on the basis of 'FDI Restrictiveness Index'. Though the actual inflow of FDI has not been as high compared to what it is in some other countries, it has improved and strengthened the capital account of the BoP of the country— the account that records the inflow and outflow of capital in the BoP accounting.

**FII POLICY**

FII relates to investment of capital in the equity markets including securities (i.e. stock exchanges) where capital can leave the economy over night. Investment in FII only reflects the investors sentiment or confidence in the stock market whereas FDI shows a long term commitment linked to the growth prospects in the economy in which investment is made.

The entry of FIIs after 1992-93 is a follow up of the recommendation of the Narsimham Committee Report on Financial System. Before 1992, only Non-Resident Indians (NRIs) and Overseas Corporate Bodies were allowed to undertake portfolio investments in India. Post-1992, the Indian stock markets were opened up for direct participation by FIIs. FIIs were allowed to invest in all securities traded on the primary and the secondary market including the equity and other securities/instruments of companies listed in the stock exchanges in India.

In 1998, Indian companies were allowed to issue bonus shares (or right shares) to the GDR/ADR (i.e. Global or American Depository Receipts) holders after obtaining necessary permission. Subsequently, the FIIs were allowed to invest in the securities of unlisted companies, treasury bills and government securities. The norms for FIIs' investment in convertible bonds were also liberalized. In short, the evolution of FII policy in India has taken the form of : (i) relaxation of investment limits for FIIs; (ii) relaxation of eligibility conditions; and (iii) liberalization of investment instruments accessible to FIIs.

**EXCHANGE RATE POLICY REFORMS**

Since 1993 the exchange rate policy has relied on the underlying demand and supply factors to determine the exchange rate with continuous monitoring and management by the RBI. Aims of exchange rate policy are to curb excess volatility, maintain an orderly foreign exchange market, maintain an adequate level of reserves, maintain international competitiveness of the rupee and restrain destabilizing speculative activities.

India's post 1991 exchange rate policy has been an important determinant of the country's economic successes since then. The successful management of the exchange rate has been a key determinant of dynamic exports (goods and services) and steadily rising inward remittances.

After a steep devaluation of June 1991 and the phased transition to a "market-determined, unified exchange rate" by March 1993, The RBI with Ministry of Finance has followed a policy of "managed flexibility" within a system of partial capital controls. In practice, this has meant a fairly active RBI intervention in forex markets to moderate market-driven volatility and maintain a "competitive" exchange rate. The combination of managed flexibility and partial capital account controls has allowed India to resolve, to a large extent, the trilemma of the famed "Impossible Trinity", which disallows simultaneous achievement of exchange rate stability, monetary independence and capital market integration. Any two of these goals may

be attained but never all three. The judicious and flexible management of the exchange rate system has played a crucial role in helping India to increase significantly her share in global exports of both goods and services.

It is noteworthy to mention that in the months following the outbreak of the COVID-19 pandemic, India experienced unprecedented FPI outflows of US$ 15.92 billion in March 2020, after recording cumulative inflows of US$ 1.42 billion in January 2020 and February 2020, with high volatility in the INR. RBI deployed several conventional and unconventional tools in order to ensure financial stability and orderly conditions in financial markets and has been largely successful in controlling the volatility in the Rupee.

## 4.5 Joining Hands with WTO and Its Impact on India

India is one of the founding members of WTO, which has played an important part in the effective formulation of major trade policies. Increasing protectionism, inadequate members in the Appellate Tribunal for dispute resolution, increasing number of Regional Trade Agreements (RTAs) and Free Trade Agreements (FTAs) etc. have resulted in member countries questioning the efficacy of WTO as an institution meant to ensure free trade and promote multilateralism. In the ongoing discussions on WTO reforms, India's proposal seeks to re-affirm the importance of development and promote inclusive growth. The broad elements of India's proposal include : (i) Preserving the core values of the Multilateral Trading System; (ii) Resolving the impasse in the Dispute Settlement System; (iii) Safeguarding development concerns; and (iv) Transparency and Notifications.

During the WTO TRIPS Council meeting, held on 15-16 October, 2020, India and South Africa jointly proposed "Waiver from Certain Provisions of the TRIPS Agreement for the Prevention, Containment and Treatment of COVID-19" for a limited time period, with a view to ensure that the intellectual property rights do not become a barrier in the timely and affordable access to medical products, including vaccines and therapeutics, and enable nations to deal effectively with the public health emergency arising out of COVID-19 pandemic. The proposal has received broad-based support from many WTO members, civil society and international organizations.

**Impact of WTO on the Indian Economy**

The World Trade Organization was established to deal with all the major aspects of international trade and it had far reaching effects not only on India's foreign

trade but also its internal economy. India is one of the founding members of WTO, which has played an important part in the effective formulation of major trade policies. The impact of the WTO on the Indian economy can be analyzed in the following ways :

The WTO has both favourable and non-favourable impact on the Indian economy.

**Favourable impacts :**

1. **Increase in export earnings :** Increase in export earnings can be viewed from in merchandise exports and growth in service exports :
   - **Growth in merchandise exports :** The establishment of the WTO has increased the exports of developing countries because of reduction in tariff and non-tariff trade barriers. India's merchandise exports have increased, no doubt.
   - **Growth in service exports :** The WTO introduced the GATS (General Agreement on Trade in Services) that proved beneficial for countries like India. India's service exports increased from 5 billion US $ (1995) to 102 billion US $ (2008-09) (software services accounted) for 45% of India's service (exports)
2. **Agricultural exports :** Reduction of trade barriers and domestic subsidies raise the price of agricultural products in international market, India hopes to benefit from this in the form of higher export earnings from agriculture. Besides, the Agreement on Agriculture under the WTO was also expected to be favourable because it would raise the world prices of agricultural commodities and expand trading opportunities for Indian agriculture.
3. In agriculture, India along with many other developing countries, have been demanding a permanent solution on the issue of public stockholding for food security purposes. This has become even more relevant in the wake of the ongoing pandemic, as the government had to step up disbursement of food grains under the public distribution programmes for ensuring food security of the masses. India has also been raising the issue of imbalances and asymmetries in the existing Agreement on Agriculture (AoA) and their implications for developing countries.
4. **Textiles and Clothing :** The phasing out of the MFA (Multi-Fibre Agreement)

will largely benefit the textiles sector. It will help the developing countries like India to increase the export of textiles and clothing.

5. **Foreign Direct Investment :** As per the TRIMs agreement, restrictions of foreign investment have been withdrawn by the member nations of the WTO. This has benefited developing countries by way of foreign direct investment, euro equities and portfolio investment.

6. **Multi-lateral rules and discipline :** It is expected that fair trade conditions will be created, due to rules and discipline related to practices like anti-dumping, subsidies and countervailing measure, safeguards and dispute settlements. Such conditions will benefit India in its attempt to globalize its economy.

**Unfavourable Impacts :**

1. **TRIPs :**

   Protection of intellectual property rights has been one of the major concerns of the WTO. As a member of the WTO, India has to comply with the TRIPs standards.

   However, the agreement on TRIPs goes against the Indian patent act, 1970, in the following ways :

   - **Pharmaceutical Sector :** Under the Indian Patent act, 1970, only process patents are granted to chemicals, drugs and medicines. Thus, a company can legally manufacture once it has the product patent. So Indian pharmaceutical companies could sell good quality products (medicines) at low prices. However under TRIPs agreement, product patents will also be granted that will raise the prices of medicines, thus keeping them out of reach of the poor people, fortunately, most of drugs manufactured in India are off-patents and so will be less affected.

   - **Agriculture :** Since the agreement on TRIPs extends to agriculture as well, it will have considerable implications on Indian agriculture. The MNCs, with their huge financial resources, may also take over seed production and will eventually control food production. Since large majority of Indian population depends on agriculture for their livelihoods, these developments will have serious consequences.

- **Macro-organism :** Under TRIPs Agreement, patenting has been extended to micro-organism as well. These mills largely benefit MNCs and not developing countries like India.

2. **TRIMS :** The Agreement on TRIMs also favours developed nations as there are no rules in the agreement to formulate international rules for controlling business practices of foreign investors. Also, complying with the TRIMs agreement will contradict our objective of self-reliant growth based on locally available technology and resources.

3. **GATS :** The Agreement on GATS will also favour the developed nations more. Thus, the rapidly growing service sector in India will now have to compete with giant foreign firms. Moreover, since foreign firms are allowed to remit their profits, dividends and royalties to their parent company, it will cause foreign exchange burden for India.

4. **Trade and Non-Tariff Barriers :** Reduction of trade and non-tariff barriers has adversely affected the exports of various developing nations. Various Indian products have been hit by Non-tariff barriers. These include textiles, marine products, floriculture, pharmaceuticals, basmati rice, carpets, leather goods etc.

5. **LDC exports :** Many member nations have agreed to provide duty–free and quota–free market access to all products originating from least developed countries.

6. **Regional inequality :** Of late, economists find it convenient to play in that the WTO-led trade liberalization policies undertaken in India since the mid-1990s are chiefly responsible for sharp increase in inter-regional inequality in income. Thus, instead of breaking the monopoly of the more advanced states, trade in India has, in effect, accentuated concentration of manufacturing in the more advanced state leading to rising inter-regional or inter-state inequality in the country. In fact, evidence suggests that regional inequality in India has been increasing in all components of income except for the primary sector where we observe a decline in inter-regional inequality.

India will have to now bear the adverse effect of competing with cheap LDC exports internationally. Moreover, LDC exports will also come to the Indian market and thus compete with domestically produced goods.

Thus the WTO is a powerful body that will enact international laws on various

matters. It will also globalize many countries and help them to develop their competitive advantages and seek benefits from advanced technology of other nations. Though countries like India will face serious problems by complying to the WTO agreements it can also benefit from it by taking advantage of the changing international environment.

## 4.6 Impact Assessment of Balance of Trade and Balance of Payments (BoP) Position

What comprises BoP in India ? The answer is not far to seek. In Indian case, BoP comprises current account, capital account, errors and omissions, and change in foreign exchange reserves. Under current account of the BoP, transactions are classified into merchandise (exports and imports) and invisibles trade. Invisible transactions are further classified into three categories. The first component is Services comprising travel, transportation, insurance, government not included elsewhere (GNIE), and miscellaneous. Miscellaneous services include communication, construction, financial, software, news agency, royalties, management, and business services. The second component of invisibles trade is income. Unilateral Transfers (grants, gifts, remittances, etc.).

Under capital account, capital inflows can be classified by instrument (debt or equity) and maturity (short or long-term). The main components of capital account include foreign investment, loans, and banking capital. Foreign investment comprising foreign direct investment (FDI) and portfolio investment consisting of foreign institutional investor (FIIs) investment and American depository receipts (ADRs) / Global depository receipts (GDRs) represents non-debt liabilities. Loans (external assistance, external commercial borrowings (ECB and trade credit) and banking capital including non-resident Indian (NRI) deposits are debt liabilities.

*Note* : India's foreign exchange reserve comprise: foreign currency assets, gold, special drawing rights ( SDRs), and reserve tranche position in the International Monetary Fund ( IMF ).

In the above context ,we are imply explaining the current position of balance of trades and BoP situation in India.

During Q1 : FY 2020-21, India's exports and imports saw a sharp contraction in line with the contraction in global trade. The decline in imports outweighed

that in exports–leading to smaller trade deficit of US$ 9.8 billion as compared to US$ 49.2 billion in Q1 last year. India registered a trade surplus in the month of June, 2020 after a gap of 18 years. With the unlocking of the economy from June onwards, a gradual revival in India's merchandise trade got underway. The trade deficit during the April-December, 2020-21 was US$ 57.5 billion as compared to US$ 125.9 billion in the corresponding period last year.

Further, trade balance with China and the US improved as imports slowed. While exports of gems and jewellery, engineering goods, textile and allied products slide, exports of drugs and pharma, software and agriculture and allied products improved. Pharma exports, in particular, hold the potential to be the pharmacy of the world.

The external sector provided an effective cushion to India during COVID-19 Pandemic period. Amid domestic and global demand and supply disruptions, India's merchandise exports fell by 21.1 per cent in the first half of 2020-21 with the contraction being more severe for imports. Exports, however, revived gradually. With the gradual unlocking of the economy, the decline in imports has also moderated to 8.3 per cent during Q3: 2020-21. While trade deficit narrowed to US$ 26.2 billion in April-September 2020-21 from US$ 88.9 billion a year ago, it stood at US$ 31.2 billion during the third quarter of the year. India recorded a current account surplus of 3.1 per cent of GDP in the first half of the year largely supported by strong services exports after a gap of 17 years. India's current account deficit averaged 2.2 per cent of GDP in the last 10 years. Reversing this trend, current account balance turned into surplus (0.1 per cent of GDP) in 2019-20 on the back of, among others, a lower trade deficit and a sharp rise in net invisible receipts. Whiile prospects of external demand normalization are underway, its pace is contingent on the global COVID-19 outlook and successful rollout of vaccinations across the world.

Various initiatives undertaken to promote exports, including Production Linked Incentive (PLI) Scheme, Remission of Duties and Taxes on Exported Products (RoDTEP), improvement in logistics infrastructure and digital initiatives would go a long way in strengthening external sector in general and exports in particular.

Balance on the capital account, was buttressed by robust FDI and FPI inflows. Moreover, RBI's interventions in the forex markets ensured financial stability and orderly conditions and have been largely successful in controlling the volatility and one-sided appreciation of the rupee.

**Overall BOP :** India, being a developing and emerging market economy, typically runs a deficit on the current account to supplement domestic savings with foreign savings to fund higher investment. The current account deficit is usually financed by a capital account surplus. However, since Q4 : FY 2019-20, India has been experiencing a current account surplus along with robust capital inflows leading to a BoP surplus.

The COVID-19 pandemic impacted external sector differently for different countries. In India, calibrated easing of lockdown restrictions narrowed contraction in both exports and imports with imports posting faster recovery leading to progressive expansion of merchandise trade deficit in 2022-23. Improving trends in India's merchandise trade have been supplemented by equity capital inflows, robust FDI inflows and sustained build-up of foreign exchange reserves of all time high of US $ 586.1 billion as on January 8, 2021, covering about 18 months of imports. The comfortable foreign exchange reserves give the much-needed space for enhanced domestic investments. The disruption of global manufacturing value chains due to the COVID-19 pandemic presents a tremendous opportunity for India to become one of the key nodes in the chain. Various export initiatives including those aimed at promoting ease of exporting–have been undertaken by the government and RBI and implementation of these initiatives would pave the way for the sustainable export performance in India going forward.

## 4.7 Impact of Capital Inflows

India has encouraged foreign capital flows ever since it embarked on the path of liberalization in 1991. Emphasis has been laid on inducing long-term capital flows rather than short-run volatile flows. Up to the early 1980s, India relied largely on multilateral and bilateral concessional finance. During the 1980s, there was also an increase in commercial loans as well as short-term borrowings and deposits from non-resident Indians that resulted in a high ratio of short–term debt to total external debt. Nevertheless, during the decade of 1980s, net capital inflows to India were almost negligible.

Indian economy experienced a surge in net capital flows following the introduction of reforms in the 1990s. Net capital inflows more than doubled from an average of US $ 4 billion in the 1980s to an average of approximately US $9 billion during 1993-2000. The proportion of non-debt in total capital flows has increased from 5% in the second part of 1980s to 40% during early 1990s and further to about

61% in 1997-98 to 2002-03. From 2003-04 to 2006-07, non-debt creating flows increased from 7373.5 to 159% of total capital inflows. Table 4.1 shows details of the division between non-debt and debt creating flows.

In what follows is that the overall level of capital inflows was little changed in the 1990s, hovering between $4billion and $10 billion. But there was a dramatic change in the composition of capital flows. Debt-creating flows such a external assistance, ECBs and NRI depoisits declined in importance. Not-debt creating inflows such as portfolio and FDI flows increased in importance.

**Table 4.1 India's capital inflows : composition [as percentage of total capital inflows (net)] annual average**

| Indicators/Period | 1990-91 to 1996-97 | 1997-98 to 2002-03 | 2003-04 to 2006-07 | 2007-08 to 2010-11 |
|---|---|---|---|---|
| 1. Non debt creating flows | 39.7 | 60.6 | 73.5 | 159 |
| (a) Foreign direct investment | 21.5 | 41.8 | 21.6 | 144.7 |
| (b) Portfolio investment | 18.2 | 18.8 | 51.9 | 14.3 |
| 2. Debt creating flows | 57.7 | 35.3 | 20.6 | 62 |
| 3. Other Capital | 2.7 | 4.2 | 5.8 | (–) 121 |
| 4. Total (1 to 3) | 100 | 100 | 100 | 100 |

Note : Debt creating inflows include external assistance, external commercial borrowing, NRI deposits, and rupee debt service

Source : RBI Handbook of Statistics, 2012, Report on currency and Finance, Various Issues.

As shown in Table 4.1, within non-debt creating flows, the proportion of portfolio investment in total capital flows were more than 50% in 2003 -04 to 2006-07, up from 18.8 % in 1997-98 to 2002-03. The proportion of portfolio flows remained low from 1997-98 to 2002-03 and again from 2007-08 to 2010-11, due to the East Asian crisis and the global sub-prime crisis respectively. A rise in the proportion of portfolio investment during the mid-2000s imparted volatility to the total capital flows. Research suggests that the standard deviations associated with

portfolio investment are much higher than those related to FDI. This increase in volatility of capital flows especially the portfolio flows had made the Indian economy more vulnerable to external shocks and also warranted an active exchange rate management policy. So we cannot say that foreign capital inflows are always good for the Indian economy. As both the East Asian crisis of 1997-98 and the Global Financial Crisis of 2008-09 has amply demonstrated that foreign capital inflows into a developing country can be a mixed blessing. Specially, for India, the capital inflow surge of 2005-08 posed serious problems of an overly appreciated exchange rate, excess domestic liquidity and an asset price boom. So capital account management in such situation was urgently called for.

**Table 4.2 : Foreign direct investment and portfolio investment in India (US $ Billion)**

| Years | FDI | FPI |
|---|---|---|
| 1990-91 | 0.10 | 0.01 |
| 1991-92 | 0.13 | 0.00 |
| 1992-93 | 0.32 | 0.24 |
| 1993-94 | 059 | 3.57 |
| 1994-95 | 1.31 | 3.82 |
| 1995-96 | 2.14 | 2.75 |
| 1996-97 | 2.82 | 3.31 |
| 1997-98 | 3.56 | 1.83 |
| 1998-99 | 2.46 | -0.06 |
| 1999-00 | 2.16 | 3.03 |
| 2000-01 | 3.27 | 2.59 |
| 2001-02 | 4.73 | 1.95 |
| 2002-03 | 3.22 | 0.94 |
| 2003-04 | 2.39 | 11.36 |
| 2004-05 | 3.71 | 9.29 |
| 2005-06 | 3.03 | 12.49 |
| 2006-07 | 7.69 | 7.06 |

| Years | FDI | FPI |
|---|---|---|
| 2007-08 | 15.89 | 27.43 |
| 2008-09 | 22.37 | -14.03 |
| 2009-10 | 17.96 | 32.40 |
| 2010-11 | 9.36 | 30.29 |
| 2014-15 | 31.25 | 42.20 |
| 2015-16 | 36.02 | (-)4.13 |
| 2016-17 | 35.61 | 7.612 |
| 2017-18 | 30.28 | 22.11 |
| 2018-19 | 30.71 | 29.07 |
| 2019-20 | 43.01 | 14.03 |
| 2020-21 | 43.95 | 36.17 |

Source : Economic Survey, MoF, 2020-21,Vol II

Both FDI and FPI flows were negligible in the pre-liberalization period and it was only after 1990-91 that these stared increasing. FDI flows to India increased consistently from 1990s to 2008-09, despite the occurrence of the global crisis in 2009-10. FDI flows declined due to the impact of the global subprime crisis. The increase in both FDI and FPI in the post-liberalization period was mainly a result of a shift in trade, industrial and investment policies.

In 2017-18, net FDI in India declined to $30 billion from a peak of nearly $35.61 billion in 2016-17 ( Table 4.2), due to high repatriation. At this level, the share of FDI in India dropped from 16 to 9.5 % of the total FDI inflows into emerging markets.

**Recent Phenomenon**

However, of late, India remained a preferred investment destination in FY 2020-21. Net FPI inflows recorded an all-time monthly high of US$ 9.8 billion in November 2020. During April-December 2020, equities witnessed inflow of at USD 30.0 billion, five times its previous year value - India was the only country among emerging markets to receive equity FII inflows in 2020. As a result of these inflows, buoyant Sensex and NIFTY resulted in India's market-capitalization to Gross

Domestic Product (GDP) ratio crossing 100 per cent for the first time since October 2010.

Robust capital inflows along with a weak dollar lent an appreciating bias to the Indian rupee since end June 2020. However, RBI's prudent interventions in the foreign exchange market limited the appreciation. While combined with a rise in gold reserves and foreign currency assets, India's foreign exchange reserves climbed to a new high of US$ 586.08 billion as on 8th January, 2020, covering more than 18 months of imports. External debt as a ratio to GDP, which is comprised primarily of private sector's external debt, rose marginally. However, the ratio of foreign exchange reserves to total and short-term debt (original and residual) improved because of the sizable accretion in reserves. Reflecting lower current receipts, debt service ratio (principal repayment plus interest payment), however, increased to 9.7 per cent as at end September 2020 as compared to 6.5 per cent at end-March 2020.

**Capital Flows Viewed from Policy Perspectives**

In recent years, there has been a dramatic transformation in the sectoral composition of both the flows and the stock of FDI. Foreign investment is no longer going into primary products or resource- based manufacturing. Today, concentration is mainly in services and technology-intensive manufacturing.

Although, unlike FDI, portfolio capital flows are more volatile (depending on the movements in share prices and the BoP position on the recipient country), on the whole, the size of such flows in India has increased substantially. An interesting feature of portfolio flows is that if the growth prospects are positive and exchange reserves are high, as is the case of India, the size of the current account deficit does not have a significant adverse impact on the size of inflows. Over time, the portfolio investments have certainly strengthened India's external position. India now has much capacity to withstand external and internal shocks. It is less dependent on official capital flows from the World Bank and the IMF, or the other developed countries including the US and the European Union. Whether the situation of large capital inflows into Indian markets will continue into the long term is not definite, as the confidence in India's economic prospects may be adversely affected if there are economic, social, other catastrophic events like COVID -19 or political uncertainty in the future.

From the policy point of view, over the long run, while foreign capital inflows continue without any restrictions, excessive reliance on such flows for long-term

investments and equity market development should be avoided, as is clear from the experience of several countries in Latin America, Africa and even Europe.

Looking ahead, India's policy for the management of capital flows should broadly centre on three objectives : (a) how to 'prevent' excessive capital flows; (b) how to avoid the adverse effects of excessive capital flows on the domestic economy in case they do occur; and (c) how to mange a foreign exchange crisis from getting out of hand in the event of collapse, for whatever reasons, of confidence in the economy.

A practical policy approach for management of aggregate capital flows is to regulate 'inflows' of portfolio capital and restrict 'outflows' of domestic capital through administrative rules. Thus India need not rush into full convertibility of capital account transactions following the recommendations of Tarapore I and II on capital account convertibility placed in 1998 and 2005 until the domestic financial system is sufficiently strong and large to cope with fluctuations in capital flows.

## 4.8 Issues Related to Accumulation of Foreign Exchange reserves

Most of the countries have adopted the definition of foreign exchange reserves as suggested by the IMF (BoP Manual and Guidelines on Foreign Exchange Reserve Management 2001), which defines reserves as external assets that are readily available to and controlled by monetary authorities for direct financing of external payments imbalances, for indirectly regulating the magnitude of such imbalances through intervention in exchange markets to affect the currency exchange rate, and /or for other purposes.

The foreign exchange reserve of any country acts, in fact, as a cushion to withstand any jolt to a sudden rise of imports or fall in exports. In the absence of adequate reserves, payments for imports or on other counts become difficult. The country may thus be starved of timely imports, which can cause serious disruptions in the domestic economy. Even in a flexible exchange rate regime, there arises the need for holding reserves so that the central bank can prevent sharp , short-term changes in the rate. It also provides the country with the necessary international liquidity, often creates confidence to the policy makers to initiate any long-run decisions. A country is in need of it in order to install confidence in the international community, meet debt servicing obligations as well as to handle the short term capital flows, also to smoothen the seasonal volatility in the foreign

exchange transaction and to counter speculative attacks on the currency. An important means of promoting investors' confidence and averting currency turmoil is the holding of large foreign exchange reserves by the central bank : not only can it then repel sporadic, probing forays by speculators to test the currency's strength, but also the knowledge of such reserves itself acts as a deterrent to attacks.

The movements in foreign exchange reserves is, in fact is the net result of all external transactions. They, therefore, provide a summary statement of the state of the country's BoP. A developing country like India has already accumulated a hefty amount of forex reserves in the post-reform period. A question that is now uppermost in the minds of observers of the Indian scene is whether India would be able to handle this large amount of reserves properly in its onward march to strengthen the economy without any adverse effects on it. It needs to be explained in the present context. The explanation is divided into two sub-sections. First of all, we highlight a prudent policy for managements of forex reserves. Thereafter, the question like whether the expanding forex reserves in India represent improvement in its economic strength, or the present level of reserve is consistent with the overall macroeconomic management of the country, is addressed.

**A. A Brief History of India's Forex Exchange Reserves**

Foreign exchange reserve positions change dramatically after the launch of the structural programmein 1991. The Table 4.3 clearly shows the stupendous rate at which the foreign exchange reserves of the country have increased. From US $ 5831 million in 1990-91 it has gone up to US $ 42281 million in 2000-01 at the compound annual growth rate of 33%. The foreign currency assets have increased from US$ 2236 million in 1990-91 to US$ 442213 million in 2019-20 The country is now sitting pretty with sufficient foreign exchange reserves on stock basis to finance more than 37.5 months of import bills compared to a horrifying import cover ratio of one month at the time of BoP crisis in 1990-91. All the criteria for defining a given reserve as sufficient are being achieved despite umpteen elections, coalitions, hung parliaments and governments. A number of factors explain this rapid increase in the foreign exchange reserves of the country.

- Impressive performance of exports and buoyancy in invisible receipts have become the driving force towards building of reserves of this order. Correspondingly to the increase in reserves, the import cover by foreign currency assets has arisen from 1.0 month of imports in 1990-91 to

a very comfortable level of mostly 37.5 months of imports in 2019-20. Forex reserves on February 2, 2007 provided an import cover of about 11 months (Economic Survey 2006-07).

- The institution of market determined exchange reserves system has led to a massive inflow. In the absence of demand for foreign exchange market, the RBI to build reserves has bought the surplus inflows.
- There has been a surge in non-debt creating foreign investment inflows especially inflow through FDI. Before the reform measure FDI in the country was almost non-existent but the facilities provided to the foreign capital and the investment climate in the country have attracted FDI thereby adding to the foreign exchange reserves of the country. Thus foreign investment inflows become instrumental behind such a good build-up.
- The country has also received foreign exchange through increased flow (in absolute terms) of debt-creating inflows like external commercial borrowing, external assistance and short-term credit.

**B. Policy for Management of Foreign Exchange Reserves in India**

The unprecedented high level of reserves, with the prospect of continued growth and accretion, has raised issues relating to the management of foreign exchange reserves. In the light of the volatility induced by capital flows, there is now a growing consensus for emerging developing countries to maintain adequate foreign exchange reserves. How much to be preserved and adequate is still an open question. India's approach to reserve management, until the BoP crisis in 1991 was essentially based on the traditional approach for maintaining an appropriate level of imports equivalent to reserves. The emphasis on import cover constituted the primary concern till 1993-94. The approach to reserve management, as part of the exchange rate management underwent a paradigm shift with the recommendation of the High Level Committee on BoP (Chairman Dr. C. Rangarajan). It is now increasingly being felt that reserves should be adequate to cover likely variations in capital flows.

**Adequacy of Reserves**

In India, the adequacy of foreign exchange reserves has to be viewed in the context of many factors, including trade and payments regime, the type of short-

term debt and various type of capital flows imbibed with latter's size, composition and risk profiles as well as types of external shocks to which the economy is vulnerable- as also the currency in circulation and the extent of current and capital account liberalization. The High Level Committee on BoP suggested that while determining the adequacy of reserves, due attention should be paid to the payments obligations in addition to the traditional measure of import cover of three to four months. The Committee recommended that the foreign exchange reserves targets be fixed in such a way that they are generally in a position to accommodate imports of three months (Paragraph 6.3). In view of the Committee, the factors that are to be taken into consideration in determining the desirable level of reserves are the need to ensure a reasonable level of confidence in the international financial and trading communities about the capacity of the country to honour its obligations and maintain trade and financial flows ; the need to take care of the seasonal factors in any BoP transactions with respect to the possible uncertainties in the monsoon conditions of India ; the amount of foreign currency reserves required to counter speculative tendencies or anticipatory actions amongst players in the forex exchange market; and the capacity to maintain the reserves so that the cost of carrying liquidity as minimal (Paragraph 6.4). In 1997, the Report of Committee on Capital Account Convertibility under the Chairmanship of S. S. Tarapore also suggested four alternative measures of reserve adequacy which in addition to traditional trade –based indicators, viz. import cover of reserves, also included money-based and debt-based.

It is true that India cannot go forward with a mere frugal measure of US $ 5-8 billion in 1990-91. The things are now altogether changed. India has stepped into the globalization era and has come a long way from the situation prevailing upto 1991. It should act, act in the living present. Before India, now there are large debt service payments and leads and lags, short-term debt and there is the existence of relatively large portfolio flows and, therefore, it is essential to hold larger reserves; otherwise, if short-term liabilities like debt and portfolio stock anyhow flow out of India, the country would lose 70 percent of its reserves. And then this inadequate balance of reserve would be of no use to meet other needs and requirements.

One way of assessing of reserve adequacy is based on a 'Liquidity at Risk' rule that takes into account the foreseeable risks that a country could face. This approach requires that a country's foreign exchange liquidity position could be

calculated under a range of possible outcomes for relevant financial variables, such as exchange rates, commodity prices, credit spreads etc.

The other one of assessing adequacy of reserves is to track the net-foreign exchange assets–currency ratio (NFA-C ratio). The present NFA-C ratio is 87 percent. That implies that forex reserve are now sizeable in relation to the currency with the public and this ratio has been rising steadily over the past several years, indicating thereby that this gives a great degree of comfort to the foreign portfolio investors and the authorities. Obviously if there happens currency expansion, this ratio would start falling and a sharp falling ratio would eventually transmit a warning signal to the foreign investors. Experts articulate that if this ratio falls below 40 percent, which is a Plimsoll line, it would be wise decisions for foreign investors to exit. Now the time has come for RBI to look into this ratio, hitherto neglected, into its monitoring systems.

Another way of assessing adequacy of reserves is to observe the reserve – liabilities ratio and to follow Guidotti Rule. The rule recommends that reserves should be adequate to cover one year's imports and capital flow requirement, that is to say, the reserve, as according to Pablo Guidotti, the former Deputy Minister of Argentina, should be sufficient for the country to live without additional foreign borrowing for one year. Taking a similar view, Alan Greenspan (1990) proposed short-term debt by remaining maturity of one year as the yardstick to measure reserve adequacy. He further extended Guidotti Rule in terms of two aspects : (i) average maturity of external debt should be three years and above; and (ii) countries must maintain liquidity at risk. Thus, the reserve should not only be able to finance the difference between the expected imports and exports but also to be sufficient to meet with the external amortization due in the next one year. On the basis of Guidotti and Greenspan Rule, India would probably need somewhat more reserves to maintain the foreign exchange rate at the desired level as well as to face volatile flows like net portfolio, non-resident repatriable deposits as well as requirements of debt servicing and the threat of impending capital flight, if any. It is a hope that India's net international investment position, that is the stock of external assets net of external liabilities, due to its hefty stock of international reserves, now the fifth largest stock of reserves in the world, which can finance about 14 months of imports, has improved.

**Table 4.3 : India's Foreign Exchange Reserves**

(US $ million)

| Years | Gold Holding of the RBI | RTP | SDRs | Foreign Currency assets held by the RBI in major convertible currencies | Forex Reserves | Import Cover (No. of months) |
|---|---|---|---|---|---|---|
| 1990-91 | 3496 | | 102 | 2236 | 5834 | 0.8 |
| 1991-92 | 3499 | | 90 | 5631 | 9220 | 2.3 |
| 1992-93 | 3380 | | 18 | 6434 | 9832 | 2.5 |
| 1993-94 | 4078 | | 108 | 15068 | 19254 | 5.4 |
| 1994-95 | 4370 | | 7 | 20809 | 25186 | 5.7 |
| 1995-96 | 4561 | | 82 | 17044 | 21687 | 6 |
| 1996-97 | 4054 | | 2 | 22367 | 26423 | 6.5 |
| 1997-98 | 3391 | | 1 | 25975 | 29367 | 6.9 |
| 1998-99 | 2960 | | 8 | 29522 | 32490 | 8.2 |
| 1999-00 | 2974 | | 4 | 35058 | 38036 | 8.2 |
| 2000-01 | 2725 | | 2 | 39554 | 42281 | 8.6 |
| 2001-02 | 3047 | | 10 | 51049 | 54106 | 9.6 |
| 2002-03 | 3534 | 672 | 4 | 71890 | 75428 | 12 |
| 2003-04 | 4198 | 1311 | 2 | 107448 | 112959 | 12.2 |
| 2004-05 | 4500 | 1438 | 5 | 135571 | 141514 | 13 |
| 2005-06 | 5755 | 756 | 3 | 145108 | 151622 | 13.2 |
| 2006-07 | 6784 | 469 | 2 | 191924 | 199179 | 13.6 |
| 2007-08 | 10039 | 436 | 18 | 299230 | 309723 | 20.1 |
| 2008-09 | 9577 | 981 | 1 | 241426 | 251985 | 15.2 |
| 2009-10 | 17986 | 1380 | 5006 | 254685 | 279057 | 17.5 |
| 2010-11 | 22972 | 2836 | 4469 | 260069 | 294397 | 19.1 |
| 2016-17 | 19869 | 2321 | 1446 | 346319 | 369995 | 33.5 |
| 2019-20 | 30578 | 3583 | 1433 | 442213 | 477807 | 37.5 |

Source : RBI, SDRs : Special Drawing Rights, RTP : Reserve Tranche Position in IMF

As a result of substantial capital inflows, the forex reserves situation for India has improved beyond the imagination. Now in 2019-20, the RBI has a reserves exceeding 477 Billion US dollar, all time high, a situation unthinkable at the beginning of liberalization when India barely had reserves to cover a few weeks of imports. Table 4.3 shows the evolution of India's foreign exchange reserve position since liberalization in 1991.

**C. Foreign Exchange Reserves and Its Implications to the Present Context**

India's total foreign exchange reserves (including gold, SDRs and Reserve Tranche position (RTP) in IMF and foreign currency assets) have increased from US $5.834 billion (excluding RTP) during 1990-1991 to US$ 477.807 billion including RTP. Since 1991-92, India has also made significant progress in all the reserve adequacy indicators, like import adequacy (measured in terms of number of months of imports that can be financed by the reserves held by the country), debt adequacy (measured by the ratio of reserves to total external debt and short-term debt, that is, it is the ability of reserves to cover particularly short –term debt liabilities,) and monetary adequacy (measured by the ratio of reserves to broad money (M3) and reserve money (Mo) For example, the import cover of reserves has increased from 2.3 months in 1991-92 to almost 37.5 months in 2019-20.

Now the question crops up whether these expanding forex reserves always represent improvement in the economic strength of the country like India or they help in its economic development. The answer is that expanding forex reserve always do not represent improvement in economic strength nor do always stand for macroeconomic stability as is exemplified in the case of Indian economy.

There is as yet no room for complacency as the bulk (i.e., 61 per cent) of these reserves comprise of short- term debt and portfolio investments (such as FIIs investments driven by the heavily bullish sentiments prevailing in the Indian stock market). The East Asian crisis of mid 1997 and Global crisis of 2007-08 portrayed these resources as highly volatile in nature.

The high growth of reserves has raised now the questions of an "optimum" level of reserves and the possible implications of the reserve built-up on an overall macroeconomic management. Earlier it was thought that the reserve must approximate about three month's equivalent of imports. This is because imports may be essential while exports depend not only on the country's ability to export but also on the demand for them from the rest of the world, which can hardly be assured. The impact of reserves on macroeconomic management deserves serious attention. First

of all, high reserve can lead to rising domestic prices and inflationary pressures in the economy. On the other, there is a cost to them as well. These reserves are practically income barren, but they have high opportunity cost (defined as the marginal product of the available alternative investment) for they could be used to repay costly external debts and /or to upgrade infrastructure etc. All available evidence suggests that these high opportunity costs have exceeded the gains from reserve accretion, especially since 1998. Further, critics argue that huge accumulation of reserves has additional macro-economic cost arising out of a sterilization of capital flows. Also, accumulating of large volume of reserves creates moral hazards and reflects insurance against weak domestic fundamentals and political uncertainty. For this reason, many economists are already complaining of "excess reserves".

If we look at the various aspects of international transactions which result in increase/decrease in forex reserve particularly since 2000-01, We find that on trade account, India is facing a regular deficit during this period and for latter period. It had also faced regular deficit since the 1990s. This indicates that the Indian importers of commodities have spent more than Indian exporters have earned. So far as service exports and imports are concerned, India is on better footing. If the current account deficit is considered, it is seen that expenditure has always been more than earnings, except during 2001-02 to 2003-04. Therefore it is clear that India's forex reserves are not expanding on the strength of India's forex earnings. In what follows, India at one hand, is facing large deficit on trade as well as on current account; on the other hand, her forex reserves are increasing. The answer lies in the capital account of India's BoP, consisting of foreign investment, borrowing, debt servicing and IMF transactions. The foreign investment inflows have increased India's forex reserves but it may result in steady outflow by means of remittance of profits, fees, royalty etc. Due to foreign assistance, commercial loans and net banking transactions to foreign currency to India, forex reserves are also going up. These have also increased additional liability on the Indian economy.

While the high level of forex reserves held by India at present termed by RBI and experts as comfortable in terms of all the commonly applied adequacy indicators pointed out at the outset, it is also important to reflect upon the cost of holding reserves, though it is true that sufficient stock of forex reserve is preventive from fortuitous speculative attacks mainly from the private traders. It is also equally true that the high levels of reserve management indicators reflect to some extent, the slack in capacity of the economy to absorb foreign savings. In other words, the import and investments absorption capacity of the economy has not expanded to

make use of foreign currency assets. Two issues are significant in this respect. There are the returns earned from deploying the reserves in various securities vis-à-vis the interest paid on external debt and the costs of building-up reserves through sustained open market operations. While the first issue entails the direct economic costs of holding reserves, the second, apart from involving costs of intermediation for the banking system, includes the consequences of prolonged sterilization on domestic money supply and price levels. It may be through that Central Bank intervention to maintain a stable exchange rate by holding reserves such as is happening in India, can solve the problem. Actually it is not. As a matter of fact, forex reserve with the central Bank typically earns very little interest, no more than 1 to 2 per cent, for instance, in the case of India. On the other hand, the finance capital which comes into the country earns rates of return (including capital gains) which are quite hefty (which after all is the reason for its flowing in). India in other words is borrowing from abroad at high rates and using the funds to earn low rates, which is indefensible. The maintenance of large forex reserves therefore entails a loss for the country

Recent experiences had shown that countries which were holding large levels of foreign exchange reserves in relation to imports, did not necessarily escape the crisis. These countries had large reserves, but these reserves disappeared quickly as they tried to defend their currencies. Some part of the reserves could not be accessed when it was most required by these countries since they were invested in illiquid assets such as real estate, stocks with low trading volume or collectibles Further, there was no transparency with regard to the precise figure of unencumbered reserves. In the aftermath of the Asian Crisis in 1997, the emphasis had shifted from measuring the adequacy of foreign exchange reserves only in relation to imports to measuring the usable or unencumbered reserves in relation to short-term liabilities, in particular short-term debt. On this subject, a notable suggestion for emerging market economies was that countries should manage their external assets and liabilities (and the so-called 'liquidity at risk') in such a way that they are able to live without new foreign borrowingfor up to a year.

We must not also forget that today the volume of private trade in foreign exchange is a staggering daily volume of more than 1.2 trillion (i.e.1012) dollars. The daily volume of private trade in foreign exchange can easily overwhelm the forex reserve of any central bank. This predominance of private finance capital has become by far the single defining characteristic of the modern phase of globalization.

Therefore fear now looms large in that a sudden bout of speculative capital inflow may perpetuate de-industrialization on an economy like India. Since the purpose of economics is to bring about an improvement in the lives of the people, voices must be raised to re-activation of public investment, together with some capital control.

It is true that India has accumulated the fifth largest stock of international reserves in the world. And India is now heading towards capital account convertibility. It is noteworthy that, judged by the amount of reserves in relation to imports, short-term debt and non-debt liabilities, and by other usual criteria mentioned, India's external shock absorptive capacity has improved dramatically in recent years and the country now ranks among the top group of developing economies in terms of her ability to counter speculative attacks on her currency.

From our analysis it appears that India has been steadily building up reserves. But it should be by encouraging non-debt creating flows and de-emphasizing debt creating flows, particularly, short-term debt. In fact, this strategy, coupled with the maintenance of an acceptable level of current account deficit of BoP and market determined exchange rate regime would be the cornerstone of the policy of external sector management. It is to be noted that reserve adequacy is now evaluated by the RBI in terms of several indicators like the size of the short-term liabilities, the possible variability of portfolio investments and other types capital flows and now not merely through conventional norms, such as the import cover

During the recent period, RBI's interventions in forex market have been largely successful in controlling the volatility and one-sided appreciation of the rupee. High levels of headline inflation, however, posits the classical trilemma before RBI to maintain a fine balance between tightening of monetary policy to control inflation on the one hand and stimulate growth on the other hand. Against the aforesaid backdrop, various initiatives undertaken to promote exports, including Production Linked Incentive (PLI) Scheme, Remission of Duties and Taxes on Exported Products (RoDTEP), emphasis on improvement of trade logistics infrastructure and use of digital initiatives would go a long way in enabling 'ease of doing exports.'

In the above context it is pertinent to say that the objectives of reserve management in India should be to preserve the long-term value of the reserves in terms of purchasing power and to minimize risk and volatility in returns.

## 4.9 Conclusion

The COVID-19 pandemic impacted external sector differently for different countries. While countries witnessed contraction in exports and imports, AEs suffered larger contraction and EMDEs, less, especially the East-Asian economies. In India, calibrated easing of lockdown restrictions narrowed contraction in both exports and imports with imports posting faster recovery leading to progressive expansion of merchandise trade deficit.

Improving trends in India's merchandise trade have been supplemented by equity capital inflows, robust FDI inflows and sustained build-up of foreign exchange reserves. The comfortable foreign exchange reserves give the much-needed space for enhanced domestic investments. The disruption of global manufacturing value chains due to the COVID-19 pandemic presents a tremendous opportunity for India to become one of the key nodes in the chain. Various export initiatives, as documented above – including those aimed at promoting ease of exporting – have been undertaken by the government and RBI and implementation of these initiatives would pave the way for the sustainable export performance in India going forward.

## 4.10 Summary

**Current account Convertibility versus capital account convertibility :** Currency convertibility refers to the right/freedom to covert the domestic currency into other internationally accepted currency and vice versa Convertibility has two dimensions: (i) current account convertibility and (ii) capital account convertibility. Current account convertibility refers to the freedom in respect of payments and transfers for current international transactions. Capital account convertibility (CAC), on the other hand, implies the freedom to convert local financial assets to foreign financial assets and vice versa at market determined exchange rate, without needing any permission from the government. In other words, CAC implies complete mobility of free and unregulated capital funds across countries with no legal restrictions.

The difference between 'fuller CAC 'and 'full CAC'?

On March 20, 2006, the Reserve Bank of India (RBI) appointed "Tarapore Committee-II" to set out the framework for fuller Capital Account Convertibility

(CAC). Following the recommendations of the Committee India embarks on fuller CAC. The title of the Tarapore Committee report was "Towards Fuller convertibility"' and not "Full convertibility". Hence distinction between them is crucial to an understanding of convertibility and its status.

**Fuller CAC :** CAC, especially its fuller version, implies movement towards a greater integration of the Indian economy with the rest of the world, a movement towards the loosening of controls on inward and outward capital flows. Today India has fuller capital account convertibility which essentially means foreign currency conversion for the purpose of capital account transactions are generally restricted by the RBI, with permissions granted only for specific kinds of transactions. For example, FDI inflows and NRI deposits are allowed in India, while all other forms of capital account conversion require RBI's approval. But If India embarks on full CAC in future, such permission is not needed to be taken. With Fuller CAC there are some capital restrictions, no zero capital regulations.

**Full CAC** would mean no restrictions on any kind of capital transactions. If there is full CAC in the upcoming years for India, foreigners would be allowed to invest freely in India and vice versa. Say an Indian wants to invest in Thailand. He invests Indian money. Now it requires permission from the RBI. But If India embarks on full CAC, such permission is not needed to be taken. India's CAC is not full as there are caps on government and corporate debt, external commercial borrowings and equity.

Should India go to full capital account convertibity ? On the risk of capital account convertibility, Jagdish Bhagwati's comment is worth-mentioning: "cease and desist from full CAC until India gains political stability, economic prosperity and substantial macroeconomic expertise". Full capital account convertibility requires several prerequisites in terms of macroeconomic policy framework and soundness and efficiency of financials markets in the light of macro-prudential regulations.

**ISI :** ISI is a trade and economic policy based on the premise that a developing country should attempt to substitute products it imports with domestically produced products.

**FDI and FII :** FII relates to investment of capital in the equity markets including securities (i.e. stock exchanges) where capital can leave the economy over night. Investment in FII only reflects the investors sentiment or confidence in the stock market whereas FDI shows a long term commitment linked to the growth prospects in the economy in which investment is made.

**East Asian crisis :** One of the explanations of the 1997 Asian currency crisis was based on self expectations of foreign investors who created the crisis. Reasons for the crisis were ; (i) a large fraction of foreign lending to Asia was short – term lending;(b) a large fraction of foreign lending to Asia was to bank, and (c) the central banks did not have enough dollar reserves to defend the then fixed exchange rate, which eventually led to floating exchange rates and large depreciation of the currency.

**Global sub-prime crisis and its impact on in India :** The crisi surfaced aroundAugust 2007 with the bursting of bubble in the sub-prime mortgages in the United States as reflected in the credit markets. Eventually the crisis had affected many of the most countries across the world including India and China. Global financial Tsunami has eventually led to contraction in India's exports, widened current account deficits, reversed capital flows with concomitant pressures in the domestic exchange market and drawdown of forex reserves, which ultimately made an inroad to have a structural change in her BoP.

**Remittances or net private transfer :** The term is most often used nowadays to describe a sum of money sent by someone working abroad to his or her family back home. In many developing countries, remittance payments from migrant workers are observed as an increasing magnitude and becoming a significant source of foreign reserve earnings. Remittances inflow is noted to be very useful in promoting household welfare, health and education particularly in developing countries. play an increasingly large role in the economies of small and developing countries. They help raise the standard of living for people in low-income nations and help combat global poverty. Inflows of remittances to India have experienced a sharp rise in last three dictates. Remittances have also emerged as a more important and stable source of foreign exchange inflow compared to official development assistance, foreign direct investment or other types of capital flows in particular in developing countries. Among countries today, the top recipient countries are India with $79 billion, followed by China ($67 billion), Mexico ($36 billion), the Philippines ($34billion), and Egypt ($29 billion) (World Bank 2019).

**Impossible Trinity :** This disallows simultaneous achievement of exchange rate stability monetary independence and capital market integration. Any two of these goals may be attained but never all three.

## 4.11 Exercises

**A. Short-answer type Questions**

1. What was the key objective of the post-1991 trade policy reforms?
2. What is managed float exchange rate?
3. Are foreign capital inflows always good for India? Give reasons.
4. Why portfolio capital flows are more volatile than FDI? On what factors these flows depend?
5. What is meant by current account convertibility and capital Account convertibility? Has India now introduced full capital account convertibility?
6. Define foreign exchange reserves?
7. What should be the objectives of reserve management in India?
8. What is Sub-prime crisis? Briefly state its impact on the Indian economy.

**B. Medium-answer type questions**

1. Why is a 'trade policy' important for an economy?
2. What are the changes that have brought about by the inflows of FDI and FDI in India? What are the implications of foreign capital inflows from policy point of view? Enumerate.
3. What is the underlying philosophy behind the ISI strategy? On what foundation is it based? What Do you find any historical significance of of this strategy?
4. What is import substitution industrialization (ISI)? "The prolonged import substitution was in terms of high effective rates of protection, market concentration, high unit cost of production and overvaluation of currencies eventually have led to anti-export bias." Discuss.
5. What are the essential features of trade policy before economic reforms in India?
6. What major strides were initiated to encourage the flow of FDI in the post-1991 years in India?
7. What is the difference between FDI and FII? What explains India's outstanding Macroeconomic performance in the halcyon years, 2003-2008?

8. It is generally argued that both capital inflows and outflows when they are large and sudden have important implications for economies. Do you agree/ Give reasons.
9. What is the nature of India's exchange rate policy?
10. What is Impossible trinity? How did India resolve, to a large extent, the trilemma of the famed "Impossible Trinity"?
11. What are the ill effects of holding excess reserves?

**C. Long-answer type Questions**

1. What are the essential features of External Sector Reforms prior to 1991 Economic Reform?
2. Write down the favourable and unfavourable impact of WTO on the Indian economy.
3. "Policies with regard to FDI have been liberalized substantially since 1991. Measures adopted ranged from opening new areas to FDI and raising equity participation limits across a wide limits across a wide spectrum of activities to bringing several sectors under the automatic approval route o the RBI." Do you agree? Give arguments for your answer. Are these measures with regard to FDI necessary and sufficient for the volume of FDIs and their spread across industries in India? What kind of impact do these foreign investments have on growth in India since 1991?
4. What are the various components of foreign portfolio investment(FPI). Which one among them comprises the bulk of portfolio inflows in India? Can an inflow of FFPI help India in strengthening its economy? Why an inflow of FPI is less preferable to IFDI?
5. " The Goddess of Wealth, Laksmi has been smiling on the RBI with forex reserves crossing from less than US $ 252 million at the end of March 1991 to US$ 477.807 billion in 2019-20 , all time high." In the light of the above statement, answer the following questions:
   (a) Can you account for the decline in India's forex reserves in 2008-09?
   (b) Why does India still hold of high reserves?
   (c) What is the appropriate level of reserves for a country like India?

(d) How does the current status of reserve appear in terms of indicators of adequacy of reserves?

(e) What are the factors that have led to the accretion of during the period? Do you think that such high reserves will necessarily show the strength of the economy?

6. Accretion of India's foreign exchange reserves has been phenomenal in recent years. India is also moving towards capital account convertibility in its capital account.

(a) What accounts for such accretion to foreign exchange reserves in India?

(b) Do such a large reserves guarantee stability of India's external payments accounts?

(c) Given such a large reserves, do you think that it is prudent for India to move towards capital account convertibility?

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# Unit - 5 ❑ India's Services Revolution

**Structure**

**5.1 Objectives**

**5.2 Introduction**

**5.3 Increasing Importance of the Services ( or Tertiary Sector)**

**5.4 Trend and Composition within the Tertiary Sector**

**5.5 Growth in the Service sector**

**5.6 Performance of India's services sub -sectors**

**5.7 Factors Responsible for the Spurt in Services Growth**

**5.8 Impact of Service Sector–driven growth on employment and poverty.**

**5.9 Conclusion**

**5.10 Summary**

**5.11 Exercises**

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## 5.1 Objectives

After reading this unit, you will be able to :

- Learn about the growth of services sector in India, its share in GDP and its contribution to GDP growth;
- describe comparative growth of different sub-sectors of the India's services sector;
- understand the reasons for rapid growth of services in India also with the good performance of services exports; and
- Also know about the impact of Service Sector–driven growth on employment and poverty after 1991.

## 5.2 Introduction

Dynamics of structural change of an economy in the growth process has been stated by Simon Kuznets. As growth proceeds, the share of agriculture declines while that of industry increases in terms of GDP growth and employment. The expectation is that labour released from agriculture would be absorbed in the industrial sector. As a result, the country shifts up from low income status to middle income/upper income status. Consequently, services sector/tertiaiy sector starts dominating in terms of GDP contribution and employment. This is the standard Kuznets' structural change model.

However, what has not been realized over the last 25 years or so in India and in many Asian developing countries is that labour released from agriculture has found new employment in the service sector (both formal and informal) in mainly low productivity occupations like trade and personal services. This sort of reverse causality between growth and employment is a pointer of the fact that the Indian growth model appears to have skipped the intermediate state. Anyway, this chapter throws light on the 'tertiarisation' of the Indian economy since the service sector is considered to be the major 'growth engine' of the economy than manufacturing. Not only this, it is the service sector that can lead to inclusive growth via forward and backward linkage effects. President Pranab Mukherjee has termed the services sector as "the sector of the current millennium"

## 5.3 Increasing Importance of the Services (or Tertiary Sector)

The most striking feature of the structural change in the Indian economy in recent decades has been the pre-eminence of services sector as the major contributor to growth, raising its share rather sharply in national output. The share of services has been consistently rising; more so since 2004-05. However, the pace of expansion was not balanced. The biggest drivers of the service sector expansion since 2004-05 were communications and banking and insurance.

The factors responsible for the rapid growth of the Services (Tertiary) Sector are :

- With the economic growth and industrial development, demand for services like transport, communication, electricity, storage, finance etc, increased tremendously and that led to the expansion of tertiary sector.

- Rapid Development of Information Technology service has proved to be a great source of expansion of tertiary sector.
- Defence, civil administration, economic and Social service like health, education, etc., too have made a huge contribution to the service sector.
- Due to increase in the income of the people has increased demand for services like hotels and restaurants, transport, communication and many other kinds of services.

So far as the industry, particularly, manufacturing industry is concerned, one interesting fact emerges is that in the industry, particularly manufacturing which has been observed historically to be the main contributor of growth, at least in the initial period of economic development, has played only a minor role in India's economic growth in recent years. For example, domestically, the share of manufactures in GDP has remained constant at the low 15 percent level since 1991 (17 percent in 2014-15, according to the new GDP series). Unlike other developed countries, India is on the way to becoming a post-industrial 'service economy', without industrialization. So India moves directly from agricultural to services economy bypassing industrial development. The reasons are not far to seek. Economist like V. R. Panchamukhi, R. G. Nambiar and R. Mehta argue that development of communication technologies and movements of people across countries have produced demonstration effect creating demand in developing countries as in the developed countries leading to larger demand for and consequently production of services.

## 5.4 Trend and Composition within the Tertiary Sector

The service sector has played an important role in enabling improved economic performance during the post-reform period. Services have been the fastest growing sector of the Indian economy in recent years and helped accelerate the overall growth of the economy. Services have also facilitated India's integration with the world economy through trade and capital flows. The phenomenal growth and export performance witnessed in services like information technology (IT) and business process outsourcing (BPO) has placed India on the global map. Services have also helped improve productivity in other sectors of the economy.

Services have exhibited an upward trend in growth over the past few decades. However, growth performance within the service sector has been uneven. The driving segments have been communication, banking and insurance, construction,

and trade and distribution services, which have grown at over 7 per cent in compound annual growth rate (CAGR) during 2000-09 while services such as railways and public administrative services have grown at less than 4 per cent. These are the sub-sectoral trends. In 2009, services constituted around 64 per cent of GDP, up from around 48 per cent of GDP in 1990. So the economy leapfrogs from dependence on primary sector to the tertiary sector.

## 5.5 Growth in the Service sector

The service sector is the largest, and one of the fastest growing sectors of the economy. Since the early days of economic reform, services sector have emerged as the economy's "leading sector". It is the most vibrant and dynamic sector in terms of contribution to national income, employment, trade flows, FDI inflows, etc. It covers a wide variety of activities such as trade, hotel and restaurants, transport, storage and communication, financing insurance, real estate, business services, community, social and personal services and services associated with construction. It is thus heterogeneous in nature. Its growth is phenomenal after the launching of the liberalization phase. That is why the current growth phase is characterized as 'service-led growth' phase and it has drawn enough global attention. India's current service Sector-propelled growth, however, belies standard development model. Instead of shifting growth structure towards manufactures from the primary sector, India has skipped from the primary sector to the tertiary sector. India is considered as an outlier among the South Asian emerging countries. It is called the lead sector as it is the largest to India's GDP and the second largest employer after agriculture.

**(1) Growth of the Services Sector :**

Given its nature and heterogeneity, the unprecedented growth of the services sector is due to the interplay of both demand and supply forces.

The services sector in India has been experiencing sustained and secular growth from the beginning. For the period 1951-52—1988-89, the growth of the secondary sector exceeded the growth of the tertiary sector. However, performance of the services sector picked up in the 1980s when the annual growth of real GDP started overtaking the industry sector. And this, in fact, resulted in higher overall GDP during the 1980s compared to the earlier periods. Since then, there had been a rapid and steady expansion of the services sector. It may be noted that the growth

rate of the services sector reached a double-digit figure for the first time during the period 2003-04—2006-07 and this fact warranted global attention. And in 2005 the World Bank did not hesitate to say that it is India's services revolution.

Above all, the growth of the services sector is less cyclical and more stable than the growth of the other two sectors. The higher growth rate of "the services sector acted as a 'valuable prop' to industry, agriculture, etc. After reaching a peak of a growth rate of 10.50 % in 2009-10, the growth rate in the services sector started decelerating to an average of 7%. In 2012-13 and 2013-14, both the agricultural and the industry sector performed so badly that this pulled down the real GDP growth rate to even less than 5%. The year 2014-15 saw a turnaround in both the secondary and tertiary sectors resulting in a higher GDP growth of more than 7%.

**Table 5.1 : GDP Shares of Sectors (in %)**

| Sector | 1950s | 1960s | 1970s | 1980s | 1990s | 2000s | 2010-11 | 2013-14 | 2014-15 |
|---|---|---|---|---|---|---|---|---|---|
| Agriculture | 55.3 | 47.6 | 42.8 | 37.3 | 30.9 | 21.8 | 14.59 | 13.94 | 17.5 |
| Industry | 14.8 | 19.6 | 21.3 | 22.3 | 23.3 | 24.5 | 27.92 | 26.13 | 31.8 |
| Services | 29.8 | 32.8 | 35.9 | 40.3 | 45.7 | 53.7 | 57.48 | 59.93 | 50.1 |

Note : 2010-11—2013-14 data relate to 2004-05 prices

Source : (i) ADB Economics Working Paper Series No. 352; The Services Sector in India; June 2013. (ii) Planning Commission's Indian Economy Related Table 2; December 23, 2014.

**(ii) Contribution to GDP :**

After studying the GDP growth rates in the various sectors of the economy, let us have a look at the associated change in the structure of GDP, as shown in Table

To start with, the ratcheting up of the overall GDP growth rate of the country from 5.7% in the 1990s to nearly 9% during 2007-08—2009-10 is attributed mainly to an acceleration in the growth rate of the services sector.

Table 5.1 shows the share of agriculture, industry and services in GDP over time. The most striking feature of India's growth story since independence to the current period has been the fastest growth of the services sector, in comparison with industry and a consequent decline of agriculture. Above all, since 2000 the

combined share of agriculture and industry has been lower than the services sector alone. In 2013-14, the share of services sector alone accounted for almost 60% of India's GDP.

What emerges from this discussion is that India's growth acceleration in the services sector, particu¬larly after 1980s, is rather unnatural in low-middle income economy. India is, thus, perceived to be an outlier.

It is pointedly clear that the structural changes that have taken place in India are not in tune with the charter of path made by the developed countries. In those countries, the sequencing pattern suggests a step by step movement: the decline in the share of agriculture in GDP has been followed by a corresponding rise in the share of industry and later in services. India, in contrast, has leapfrogged from the primary to the tertiary sector thereby skipping the secondary sector. This kind of growth path—an excess growth of the services sector—may be enthusiastically called 'services sector revolution'. India has been transforming more towards post-industrial service economy instead of an industry-oriented economy. Anyway, this goes against contemporary economics theories.

Moreover, India emerged as a leader in the export of business services. The share in world exports of commercial services climbed. The services component swelled and swelled and commands over about 57% share in the GDP at present.

Export-oriented services are not only the only type that has witnessed rapid growth since the early 1990s. Rate of telephone services or miscellaneous services during 1992-6 actually exceeded that of business services. But since 2006, business services continued to dominate.

The share of trade in services in India's GDP quadrupled from 3.3% to 20% between 1990 and 2016. The growth rate of services exports was higher than that of imports.

There has been a striking transformation of India as a net exports of services from being a net importer in 2005. Growth of traded in services in India was faster than other countries.

The dynamism of services trade is a result of India's emergence as hub for IT software development and other IT-enabled services, also referred to BPO services. In these services, India is recognized as the global leader. According to the Indian Ministry of Information Technology, India's exports of IT and ITeS services were of the order of USD 117 billion in 2016-17. In the Global Services

Location Index by AT Kearney, a global consultancy organization, India was ranked first globally ( Table 5.2), a position it has consistently retained since the inception of the index in 2004.

**Table 5.2 : Ranks of Some Asian Countries in Global Services Location Index**

| Country | 2004 | 2007 | 2011 | 2017 |
|---|---|---|---|---|
| India | 2 | 1 | 1 | 1 |
| China | 2 | 2 | 2 | 2 |
| Malaysia | 3 | 3 | 3 | 3 |
| Thailand | 13 | 4 | 7 | 8 |

Source : Based on atkearney.com

## 5.6 Performance of India's services sub-sectors

Services are indeed a diverse or heterogeneous group of items. It includes variety of activities like trade, hospitality, transportation, communication, entertainment, health, education, public services and many more. In Table 5.3, the average shares of these major categories in the GVA of the services sector over the decades since 1950-51 are given. To highlight the recent trends, we have also presented average shares during 5-year intervals since 2004-05.

**Table 5.3 : Decade-wise Average Share of Sub-Sectors of Services**

| Period | Trade, Hotels & Restaurants | Transport and Storage | Communication/ Services related to Broadcasting | Finance, real estate, Ownership of dwellings and Professional Services | Public Administration and Defence, and Other Personal Services | Constr-uction | All |
|---|---|---|---|---|---|---|---|
| 1950s | 17.3 | 6.4 | 0.5 | 36.4 | 22.3 | 17.1 | 100 |
| 1960s | 18.4 | 7.1 | 0.6 | 30.3 | 22.7 | 20.9 | 100 |
| 1970s | 18.7 | 8.0 | 0.8 | 28.7 | 24.3 | 19.7 | 100 |
| 1980s | 18.7 | 8.7 | 0.8 | 31.2 | 23.8 | 16.9 | 100 |

| Period | Trade, Hotels & Restaurants | Transport and Storage | Communication/ Services related to Broadcasting | Finance, real estate, Ownership of dwellings and Professional Services | Public Administration and Defence, and Other Personal Services | Constr-uction | All |
|---|---|---|---|---|---|---|---|
| 1990s | 18.3 | 8.2 | 1.1 | 36.1 | 21.9 | 14.5 | 100 |
| 2000s | 19.0 | 8.2 | 2.6 | 35.5 | 26.1 | 14.7 | 100 |
| 2010s | 19.9 | 8.3 | 2.8 | 34.3 | 20.7 | 14.1 | 100 |
| Recent Sub-Periods | | | | | | | |
| 2004-2008 | 19.2 | 8.4 | 2.8 | 35.0 | 19.2 | 15.5 | 100 |
| 2009-2013 | 18.7 | 8.5 | 2.8 | 33.3 | 21.3 | 15.5 | 100 |
| 2014-2019 | 20.6 | 8.1 | 2.8 | 35.0 | 20.4 | 13.2 | 100 |

Source : Ministry of Statistics and Programme Implementation

Major services sub-sector that have flou¬rished over the decades are : (i) trade and tourism services, (ii) transport-related services, (iii) real estate services, (iv) select business services like IT and ITES services, engineering and consultancy services, R & D services, health care services, banking and financial services, education and skill development, telecom and related services.

From the 1990s, the only categories to show distinctly increasing trend in the share of GVA are (1) Trade, Hotels and Restaurants and (2) Communications and Services related to Broadcasting. In the case of transportation, while there is an increase upto the 1980s, since then the shares have remained stagnant. In the case of trade, hotels and restaurants, dominated by wholesale and retail trade, the rise in output share may be linked to the increasing overall consumption demand, rising urbanization that may have led to increased reliance on markets for consumption and in the case of Communication and Services related to broadcasting, the sharp increase is clearly related to the communications revolution in the country led by the telecommunications, a story of both an advent of new technology-mobile telephony and policy reforms that allowed private sector participation in the sector. Communications have turned out to be quite intrinsic to economic activities across all production sectors as much as an item of consumption.

In Table 5.4, we have summarized the average growth rates of the major sub-sectors of services. From the 1980s, growth accelerated in most of the sub-sectors, with some fluctuations. The growth in the services, therefore, has been nearly across the board and for the sector as a whole, average decadal growth rate has doubled compared to the period of 1970s. Decadal annual average growth rates have exceeded 8 per cent in one more decades since the 1980s, with the services related to Communications and Broadcasting registering 14-15% growth during the 1990s and 2000s. In the case of construction, 2009-10 onwards, there has been deceleration in growth.

**Table 5.4. Decade-wise Average Year on Year Growth Rates of GVA (constant prices) of Sub-sectors of Services : (%)**

| Period | Trade, Hotels & Restaurants | Transport and Storage | Communication/ Services related to Broadcasting | Finance, real estate, Ownership of dwellings and Professional Services | Public Administration and Defence, and Other Personal Services | Constr-uction | All Serv-ices |
|---|---|---|---|---|---|---|---|
| 1950s | 4.85 | 5.40 | 6.76 | 2.79 | 3.48 | 5.76 | 3.93 |
| 1960s | 5.18 | 5.56 | 6.78 | 3.09 | 5.62 | 7.18 | 5.04 |
| 1970s | 4.31 | 5.59 | 6.59 | 3.87 | 4.36 | 1.95 | 3.79 |
| 1980s | 5.93 | 6.14 | 5.88 | 8.30 | 6.02 | 4.83 | 6.49 |
| 1990s | 7.48 | 6.29 | 14.44 | 8.08 | 6.39 | 5.63 | 7.13 |
| 2000s | 7.03 | 8.54 | 15.10 | 6.67 | 7.46 | 9.48 | 7.59 |
| 2010s | 9.76 | 6.55 | 6.49 | 7.66 | 7.07 | 4.86 | 7.39 |
| Recent Sub-Periods | | | | | | | |
| 2004-2008 | 7.10 | 9.04 | 7.39 | 7.49 | 8.55 | 11.44 | 8.29 |
| 2009-2013 | 8.17 | 7.62 | 9.91 | 7.31 | 7.81 | 5.81 | 7.37 |
| 2014-2019 | 9.96 | 5.99 | 5.99 | 7.76 | 7.97 | 4.39 | 7.57 |

Data Source : Ministry of Statistics and Programme Implementation

**Recent Phenomenon**

Services sector's significance in the Indian economy has been steady, with the sector now accounting for over 54 per cent of the economy and almost four-fifths of total FDI inflows. However, the year 2020 was a peculiar year marred by the COVID-19 pandemic and consequent nationwide and worldwide lockdown measures implemented since March, 2020. The contact intensive services sector was severely impacted, particularly sub-sectors such as tourism, aviation, and hospitality. The first half of FY 2020-21 saw services sector contract by almost 16% on YoY. This decline was led by a sharp contraction in all sub-sectors particularly 'Trade, hotels, transport, communication & services related to broadcasting', which contracted by 31.5 per cent in 2020-21.

In the wake of the Covid-19 pandemic, most of the sub-sectors of the services sector witnessed a contraction in growth during 2020-21. Aviation and tourism declined sharply in 2020. Only 2.46 million foreign tourists arrived in India during January-June 2020 as compared to 5.29 million during January-June last year. Consequently, foreign exchange earnings from tourism declined to US$ 6.16 billion during the first six months of 2020.

**Implications of 'service sector-led growth'**

There is an interesting debate about the implications of 'service sector-led growth'. Some have viewed this positively, suggesting that it represents a new development paradigm and may enable India to skip pollution-intensive industrialization.

The services sector has consistently made an important contribution to India's balance of payments .India currently runs a deficit in merchandise trade and a trade surplus in services. The ratio of services exports to merchandise exports had increased enormously over the years. IT revolution has increased the tradability of services such as outsourcing, call centres and back-office business services. This has led to increased world trade in services. The service sector has been the largest and fastest-growing sector of the world economy. There has been a shift of FDI from manufacturing to the services sector. These changes have been mirrored in India. Services exports from India increased by 17% per annum over the 1990s.

In 1993, India's service exports, particularly were just above $5 billion. By 2000, they had crossed $15 billion, by 2010, well above $100 billion and by 2018, above $200 billion. In 2014-15, Service exports were 50% of export of goods.

By 2019-20, the ratio reached 68%. The dynamism in service exports is evident. Computer services and business services accounted for 64% of service exports in 2019-20. The foothold India has achieved as an exporter of services exports, particularly the IT and IT enabled services, has been possible through a number of factors, those that drove the production and sales and a policy environment that was positive towards the growth of this nascent sector. The demand for India's exports has remained both because of the price advantage Indian exports offered and the scale of supply system that quickly developed in the country. There have been concerns related to the geographically concentrated nature of demand and the non-tariff barriers to services trade that began to emerge in the importing countries. Sustaining service exports is crucial to India because of the high quality jobs they have provided and the catching up of technology that has become possible because of the need for this sector to be globally competitive.

## 5.7 Factors Responsible for the Spurt in Services Growth

The services sector has the highest sectoral contribution in the country's GDP—larger than the combined contribution of the agricultural and industrial sectors. Today, it stands as the most attractive sector for foreign direct investment (FDI) inflows. The combined FDI share of financial and non-financial services, construction development, telecommunications, computer hardware and software, and hotel and tourism constitutes almost 48% of the cumulative FDI equity inflows during April 2000-May 2015. Anyway, the rapid surge in services growth is attributed to both demand factors and supply factors. These factors are explained below. However, the growth in the services sector is the interplay of both the domestic and global factors.

**(i) Economic affluence :** Middle class population whose size has been expanding phenomenally is one of the main drivers of economic growth. As their incomes continue to rise, people's needs become less 'material' or demands for tangible goods peter out. Obviously, the demand for services or intangible goods tends to rise as we see a growing demand for health, education, entertainment, etc. These people are domestic consumers with a high income elasticity of demand for services and foreign consumers with a growing demand for India's services exports.

Thus economic prosperity leads to structural changes in consumer demand—

a clear shift from physical or manufactured goods to non-material or non-tangible services. What India has been experiencing through the growth of the services sector, particularly after reforms introduced in 1991, is the stage of 'post-industrialization' or 'deindustrialization'. Researchers have shown that the growth of private (final) demand accounts for about half of the services sector output.

**(ii) Role of liberalization :** Prior to 1991, the services sector like the other sectors of the economy, was constrained by self-reliance and undue restrictive and regulatory government policies. When viewed the performance of the services sector after 1991, one may find a 'positive correlation between the degree of liberalization in a services sector with regard to trade and FDI policies, and its access to external markets and the growth exhibited in that sector with regard to output and employment opportunities'. Opening up of many areas of activity to the private sector (e.g., telecom services invited private sector in the mid-1990s) also resulted in fast growth of some services sector. Business services, like IT and IT-enabled services, financing, insurance, etc., have been liberalized by making market-oriented reforms. This has resulted in higher growth rates in these activities.

Among the services sector that have boomed recently in India is the software industry, rather than hardware industry because of utilization of India's stock of technical and scientific manpower as well as the outcome of policy choices. Hardware industries in computer were handicapped by high tariffs leading to sluggish growth of hardware industries. The reforms in the 1990s cut the tariffs on hardware across the board. "The result", as explained by R. Nagaraj, "was that India was able to utilize its low cost engineering skills to produce software services for export, though the country lost an opportunity to create an efficient hardware industry. As a fibre optic network spread across the world, dramatically reducing the cost of communication, the out-sourcing industry was born, turning non-tradable services like office work into tradable outsourcing back office operations." There are other areas of activity where opening up is rather restricted and thus growth performance is unsatisfactory.

Liberalization or market-oriented reforms in the domestic industrial environment, liberalization of the financial sector as well as some segments of infrastructure services, etc., are undoubtedly great contributor to the

growth acceleration of the services sector as not only greater competition has ensured but also Indian economy has been integrated with the global markets more intensively. As this sector has been geared to compete with the MNCs/TNCS and outside the country, the efficiency and productivity of the services sector have experienced a rapid surge. Further, liberalization in certain services (like telecommunication) to FDI has been a great booster to augment export opportunities (like IT and BPO services). Rupa Chanda adds that the services sector has not only to be credited for its over-performance but also it has been playing an important role in India's integration with world trade and capital markets. This is indeed a great achievement.

(iii) **Technological improvement :** It is the technological advances that have stimulated the growth of the services sector. It is because of technological breakthrough, a battery of new activities or products have become available. One finds an increasing usage of internet in the case of the IT sector, telecommunication (cellular phone services) and credit/debit cards, ATMs, etc. in the provisioning of financial services.

(iv) **Splintering :** On the supply side, Jagdish Bhagwati argues 'splintering' (that is, in their drive to becoming more competitive, manufacturing units increasingly outsource functions such as accounting or payroll management, thus giving rise to a flourishing services industry) as a possible explanation for the rapid services sector growth.

(v) **Regulation:** It is generally believed that the IT and ITeS sector grew rapidly because it was not constrained by the shackles imposed by the government on manufacturing activity.

(vi) **The Role of Liberalization :** Liberalization has boosted the growth of the services sector significantly. Even in the technology-driven sectors, the removal of government-imposed restrictions has become important.

(vii) **Market-oriented reforms :** Market–oriented reforms in India have helped for growth in services sector.

(viii) **Mutual dependence of Industrial and services Growth :** The increasing use of services in manufacturing in the 1990s favourably affected total factor productivity (TFP).

## 5.8 Impact of Service Sector–driven growth on employment and poverty

Growth of services dominating India's overall economic growth has attracted much attention in respect of its implications to employment. Do the services create adequate employment in an economy in which employment generation is the most crucial challenge ? Does the services sector 'absorb' work force, provide quality employment ?

**Earlier Story**

The fact is that the service sector's contribution to overall employment has risen. According to the 2001 Indian Census statistics, its share in employment rose from 20.8 per cent to 25.1 per cent between 1991 and 2001, while during the same period, its share in GDP increased by over 10 per cent, implying low employment elasticity. According to the Economic Survey, the tertiary sector's share of employment has increased modestly from 21.2 per cent in 1993-94 to 25.4 in 2007-08 and 28.7 per cent in 2014-15. This indicates that India has witnessed a relatively jobless services sector growth during the post-reform period. This is unlike the experience of other developing countries. While the share of services in employment was as high as 76.6 per cent in Brazil and 47 per cent in China, the share of services in employment was only 28.7 per cent in India in that year. Here in India, most of this employment is concentrated in trade and distribution, construction, hotel and restaurants and community and personal services segments, while on the other, communication and financial services have lower employment elasticities. Moreover, employment increased at a slower rate as compared to output in the services sector.

**Recent Story**

The Periodic Labour Force Surveys are now an important source of information on employment both on quarterly and annual basis. The findings for the recent years pinpoint to the challenges. The average distribution of employment (usual status: principal + subsidiary status) for 2017-18 to 2019-20 points to the challenges. While the share of services, excluding construction in output or GVA now exceeds 55%, the share of employment at the national level is only 31%. The primary sector (agriculture & allied sectors) accounted for 44% of employment although its share in GVA was less than 15%. The output of services has expanded replacing agriculture and allied sectors contribution, but it has not been able to absorb employment proportionately.

The survey findings also pinpoint to another striking feature of the employment across sectors. Employment in the rural areas is dominated by primary sector and services dominate the urban areas. Secondary and tertiary sectors contribute nearly the same level of employment in the rural areas and the secondary sector contributes a third of employment in the urban areas. Jobs created by the tertiary sector are, therefore, mainly in the urban areas. There is a need to explore this aspect of employment at a more disaggregated level in view of the implications of dominance of services in urban jobs. How can rural workers take the benefit of growing opportunities in the tertiary sector ?

The policy challenges of meeting the employment requirements in terms of both the number of jobs and the quality of jobs have been persistent. The faster pace of changes in the skills required given the changes in technology in different sectors has made the task even more challenging. The relatively low elasticity of employment with respect to output is also an added challenge. Ramaswamy (2021) provides an assessment of the employment that could be generated by the service sector. Even with the significant pace of output growth between 2011-12 and 2020, the share of services in total employment generated is not expected to increase substantially. Faster expansion of service sector output is likely to happen in sub-sectors that require highly skilled labour. The employment and productivity issues have been highlighted by other studies as well. Pais (2021) points to the lower share of employment accounted by the sectors that show high output growth. Again the issue is about the potential for increasing the output of the sectors in which productivity is higher so that more labour is employed in such sectors.

**The Role of Service Sector to Poverty Reduction**

Services sector's growth alone cannot reduce poverty of the huge population. This then requires manufacturing sector to perform and become dynamic and vibrant. A modem, economy cannot escape this industrialization stage. The leading sector role has to be played by the manufacturing sector to reduce poverty in the country.

Wage inequality in the service sectors is also high. The skilled labour in the services sector get disproportionately higher wages than other sectors. Since informal sector is predominant in the services, low-skilled workers are then placed at a high disadvantages. That is why it is said that India must focus on the manufacturing sector as it can act as catalyst to reduce poverty in a meaningful way and employment multiplier is higher than the services.

## 5.9 Conclusion

We know that agricultural productivity improvements lead to both a push for demand for manufactured products and make cheap labour available to expand manufacturing and with the resulting higher income levels the demand for services would take the transformation process further. It is, however, the role of technology revolutions shaping the economy that have influenced the transformations in unpredictable ways than the simple rules. As Rangarajan (2017) notes, in the same way technology benefitted industrial revolution, the present services revolution in India is marked by the technology changes in information processing and communications. The manner in which information is processed, goods are transported and services are delivered have become so much faster that output of services has grown enormously.

Evidence shows that the share of agriculture and allied sectors in total GVA declined from 61.6% in 1950-54 to 16.1% in 2015-19. For services, including construction the increase was from 25.5% to 65.9% in the same period. In the case of industry, the changes have not been uniform after 1990-91, showing slight decline in its GVA share. Services, have therefore been the dominant drivers of economic growth, especially from the second half of the decade of the 1980s as the share of services began to exceed the share of both industry and agriculture then onwards In other words, the rise of services in the economy as its dominant component has been in evidence for more than 30 years.

But the fact of the matter is that, despite being the largest contributor to GDP, the employment potential of services sector is not significant. The relatively jobless nature of growth that is being observed in the country's services sector is pointer to the fact that agriculture and industry are to be grown rapidly. Another concern of the services sector is that it has generated a poor quality of employment in a number of services leading to a high degree of contractualisation of labour and informalization. These are low productivity sectors. Thus the conditions of employment are required to be improved.

Transformation that is taking place in India's economy, especially over the last three decades, in which service sector has emerged as the dominant sector in terms of its output share presents both benefits and challenges. That the sector's faster pace of output growth has been possible both because of the sector's ability to carve out a niche for itself in a fast growing and technologically advanced segment

and also policies that provided a relatively favourable business enterprises. India may now be entering a phase in which the services, especially the 'modern services' will be increasingly important inputs in the production and operational processes of all the sectors of the economy. Digitalisation has opened up opportunities for scaling up operations of the firms. The opportunities for smaller firms to take advantage of the new technology-intensive mechanisms for operations would require effective access to such mechanisms.

The Covid pandemic that continues to inflict impact the lives, businesses and livelihoods has affected all sectors in the economy including services. The services such as tourism, travel, accommodation, restaurants, trade and entertainment have suffered from much reduced business opportunities, both as a consequence of restraints on consumption expenditure and restrictions on operations to control the spread of the pandemic. One part of the services, IT and IT enabled services provided much needed channels of communication and transactions. These services, along with health services, have also been critical now in coordinating the efforts of vaccination against the new infections. Education services, however inadequately, kept the links alive between the students and the teachers. The pandemic experience has shown the need for strengthening the health and education sectors. It has also shown the advantages technology-enabled operations. Adoption of these processes in practice will place much greater demands on skilled labour.

The development agenda of providing universal access to health, education, shelter and livelihood will require expansion of services sector.

This then requires manufacturing sector to perform and become dynamic and vibrant. A modem, economy cannot escape this industrialization stage. The leading sector role has to be played by the manufacturing sector.

## 5.10 Summary

What the Indian economy has witnessed in the post reform period is a services-led growth or services revolution. During the period from 1990 to 2020-21 the share of services in GDP/GVA has increased very rapidly. It has contributed enormously to growth trajectory. They are fast growers and trend growers : A brief study for different sub-sectors follows :

**Business services :** This is the fastest growing sector. This is mainly due to the growth of the IT sector.

**Communication Services :** Growth in this sector has been propelled by the fast growth in the communication sector. The contribution of communication services to GDP growth which was just under 1 per cent in 1990-91 rose to more than 14 per cent in 2006-07.

**Banking & Insurance sector :** In the banking and insurance sector, growth rate increased enormously. The contribution to banking and insurance sector to GDP growth became as high as 13.7 per cent in 2006-07.

**Community services, Hotels and Restaurants :** Growth in these sectors has picked up momentum in recent years. The gowth in the community services is due to the rapid gowth of education and health services.

**Trade :** The largest service sub-sector in India is trade. India's services exports have grown from a mere $2.9 billion in 1980 to $ 108 billion in 2010. India witnessed also services trade surplus over the years, which helped offset its growing trade deficits in goods. India has also outperformed other economies, including China. India's share in world services exports has risen from less than 1 per cent in the 1980s and 1990s to 3.1 per cent in 2010.—its services exports grown much more rapidly than its merchandise exports. Also there has been a shift in the structure of India's services exports away from traditional services like transport and travel towards emerging areas such as business services, with computer and information services.

**'Railway and Transport by Other Means':** Railways' share in in GDP was only 1.0 per cent in 2010-11, while the share of 'transport and other means' was 5.5 per cent per annum.

**Public Administration and Defence :** The rate of growth these sub-sector averaged 6.0 per cent per annum in the 1990s. The growth became 9 per cent during the period from 2005-06 to 2010-11.

**Personal services :** The rate of growth of personal services almost doubled in the 1990s as compared to the 1980s. The rate of growth of personal servives stood at 5.8 per cent per annum over the period 2005-06 to 2010-11.

## 5.11 Exercises

**A. Short-answer type questions**

1. What is meant by services sub-sector ?

2. Name some of the items in the services sub-sector. What are their importances?
3. What is meant by India's services revolution ? Does it go against the contemporary economic theories?

**B. Medium-answer type questions**

1. Write down the contribution of services sector in India.
2. Which services have grown rapidly ?
3. What explains rapid services growth ?
4. How has the services sector been affected by COVID-19 Pandemic ?
5. Do you agree with the statement that India is performing better in the field of services exports ? Give reasons

**C. Long-answer type questions**

1. What led to the rise of services in the Indian economy ?
2. What are the key feature of 'services growth revolution' in India that has been its steady and sustained nature over three decades ?
3. Growth of services dominating India's overall economic growth has attracted much attention in respect of its implications to employment. Do the services create adequate employment in an economy in which employment generation is the most crucial challenge ? Does the services sector 'absorb' work force, provide quality employment ? Explain.
4. The rapid surge in services growth is attributed to both demand factors and supply factors. Do you agree with the statement? Give reasons for your answer.
5. (a) Show that services growth in the last decade differs significantly from that of manufacturing and agriculture.

   (b) Identify the sub-sectors within services that were the growth drivers during the period.

   (c) It is generally understood that improvements in supply side conditions facilitated services growth since the Mid-1990s. How significant is demand in determining services sector growth during the first two decades of the present century.

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# Unit - 6 ❑ India's Growth Experience

**Structure**

**6.1 Objectives**

**6.2 Introduction**

**6.3 Seven Decades of India's Growth Experience**

**6.4 Reforms as Catalyst to the Growth Process**

**6.5 Conclusion**

**6.6 Summary**

**6.7 Exercises**

**6.8 References**

## 6.1 Objectives

After reading this unit, you will be able to :

- Have a broad idea about seven decades of India's growth experience with a transition from import substitution to export-led growth;
- Answer the question : Do economic reforms act as a catalyst to the Indian growth process?

## 6.2 Introduction

After independence India went in for a socialistic model of self-reliance. The task of national reconstruction fell on the government of Independent India. With a fragmented and weak private sector, the role of government was not limited to social development and redistribution of income, but extended to manufacturing and the provision of basic services to citizens. In trying to become self-reliant through the building of heavy industries, the country, being fearful of outward economic integration preferred an inward-looking trade and industrial policy surrounded itself with barriers on inward foreign investment, particularly in the

areas of industrial licensing, tariffs and controls. Markets were restricted through reservations for the public sector and extensive controls on production, composition of production, investment, and trade. This prevented India's integration into the world economy.

This restrictive economic environment remained in place for the next four decades. India became relatively isolated from the rest of the world and produced Hindu growth rate—a term connoting a disappointing but not disastrous outcome—as sarcastically said by Raj Krishna of 3.5% covering the period from 1951 to 1980 (the first three decades of planning), a period in which import duties were among the highest in the world, FDI was prohibited in many sectors of the economy, and there was extensive regulation of interest rate as GDP per capita was minimal. In the words of Raj Krishna : For 32 years the rate of growth of national income has been stagnating around a miserable mean of about 3.5 per cent. This rate keeps India as low as 71st in the list of 104 countries ordered according to the rate of growth of income per capita (Raj Krishna, 1984). The result was that India fell ever further behind its Asian competitors. In round numbers, Pakistan's GDP over the same period grew by 5% a year, Indonesia's by 6%, Thailand's by 7%, Taiwan's by 8% and South Korea's by 9%. Over the same period, industrial output grew on an average by only 6% a year. In Pakistan it grew by 8% a year, in Indonesia it grew by 9%, in Thailand by 9 %, in South Korea by 10% and in Taiwan by 12%.

It was not until the mid-1980s when Rajiv Gandhi was the Prime Minister that the seeds of reform and piece–meal liberalization were sown. Rajiv Gandhi had the opportunity and the mandate of the people to usher in contemporary economic principles of free enterprise and even to undertake constitutional amendments if necessary. What changed in the 1980s were three things. The first was a shift toward integration with the world economy. The second was a shift in entrepreneurial attitude. The third was a belief that the old Nehru dynasty order—shackled by the socialist policies and the 'License-Permit–Quota Raj' had come to an end and that the rules of the economic game had changed. These deeper changes had important implications for Indian growth. In effect, the growth rate of real GDP has risen to more than 5 per cent since 1980-81, especially since mid-1980s. That is why the post-1980-81 period is considered the period of economic shift to the higher growth path (not the post-1991) and is referred to as the Indian growth turnaround. Fast growth in India since the early 1980s has placed it among the top nine rapidly growing economies in the world.

It was in the early 1990s, that India begins cautiously to introduce economic liberalization and has undergone wide ranging economic reforms initiating stabilization and structural adjustments in the wake of an unprecedented balance of payments crisis that brought India on the verge of defaulting on its foreign loans. That compelled the country to seek and to take out a \$1.8 billion from the IMF and to introduce macroeconomic stabilization measures to reduce the budget deficit and to devalue the Rupee. The IMF agreed but only after India had introduced reforms such as cutting license restrictions, privatizing state-owned industries, and opening the country to additional foreign investment. With the economy becoming integrated more and more with the world economy, key reforms undertaken in India include trade reforms, investment reforms, fiscal reforms, financial sector reforms, privatization and industrial reforms as well as dismantling of "License-Permit-Quota Raj." Markets have come to play a far better role in the economy since the reforms in 1991.

## 6.3 Seven Decades of India's Growth Experience

Economic development in India was initiated in 1951 through the formulation of Five Year Plans (FYP), which set the direction of growth for the Indian economy. The Government' economic policy was predicted on four basic promises. First, the economy would not achieve rapid growth and egalitarian income distribution under free markets; therefore, the state must intervene in multiple ways. As a consequence, a comprehensive regulatory apparatus whose wings spread to all sectors of the economy emerged. Second, the economy should pull itself up by its own bootstraps, which meant in practice that it should operate almost as a closed economy, producing as many products as possible domestically and assigning a marginal role to foreign trade. Third, the public sector should occupy a commanding height in the economy, producing basic goods like steel and machinery, with consumer goods playing a complementary role. Further, the growth should benefit the most disadvantaged classes of society, affording them more employment opportunities, and more equal income distribution.

Looking back in the past it reveals that the target GDP growth rate in the First Five-Year Plan (1951-56) was modest (2.1 per cent per annum). The performance of the economy during this period was good (growth rate 3.6 per cent) when compared to this target. Growth was progressive and steady.

Encouraged by the success of the First FYP, Feldman-Mahalanobis- Nehruvian model-based Second Five-Year Plan (1956-61) was launched. This plan shifted gears from the agricultural emphasis of the First Five Year Plan and focused on rapid and intensive industrial development through central planning and public ownership. This plan set the pattern for future industrial policy, emphasizing import substitution strategies and state ownership of heavy and capital goods industries. This plan called for a smaller role for the private sector, which the state increasingly regulated. Its ultimate goal was to turn India into a self-sufficient economy, increase national income, and reduce unemployment. Economic growth was viewed as a function of investment. It targeted a real annual growth rate of 4.5 per cent, which could not be achieved (the perceived growth rate was 4.1 per cent). GDP did not increase at a steady rate. The plan ran into difficulties in the late 1950s because of serious BoP problems and food shortages, both of which were linked to the neglects of export possibilities and of agriculture. Inflationary pressure intensified. While in the first year of the Second-Five-Year Plan (FYV), the growth rate was 5.6 per cent, crop failure in the following year resulted in a sharp decline in growth. In subsequent years, quick recovery came from substantial increase in agricultural output due to favourable weather conditions. From the early phase of development, India was dependent on natural rainfall for its agricultural production, and this restricted its growth rate.

The Third FYP (1961-66) continued on similar lines as the second, concentrating on industrial development and expansion led by the state.This was comparatively a bigger plan in terms of investments and targets. It had contemplated a 5.6 per cent annual growth rate. The actual performance was disappointing because of two disruptive wars, first with China in 1962 and then with Pakistan that broke out in 1965) (which forced an increase in allocation for defence and weakened India's capacity to mobilize resources for growth and development and severe drought. In the fourth year, due to a very good harvest, real GDP rose by about 7.4 per cent; the following year faced another crop failure which reduced the compound rate to only 2.5 per cent. During the next three years, long-term planning remained suspended and the GDP trend was influenced by the fluctuations in the harvest, Yet these three Annual Pan period ( 1969- 69) witnessed 3.7 per cent growth rate—a somewhat better growth rate than the Fourth Plan.

It is clear now, while India's planning strategy in the 1960s clearly emphasized the need o accelerate growth; it did not actually succeed in generating faster growth

as targeted. Unfortunately, not enough effort was made to question why growth targets were not being achieved

The problems of managing foreign exchange scarcity dominated policy agenda in the 1970s. The denial of foreign assistance, promised as a part of the devaluation package, led to the Fourth FYP (1969-74) emphasizing self-reliance and reduced dependence on external aid. The Plan had targeted a growth rate of 5.7 per cent per annum. Policy-makers paid proper attention to the fact that the Indian economy in the past had fluctuated with the harvest (depending on the natural rainfall), and accorded high priority to agricultural development. The strategy was to minimize the element of uncertainty that derailed growth targets in the past. Hence, the Plan categorically emphasized stability with growth. However, the annual growth rate was somewhat very low (3.3 per cent) due to a sharp price rise, power crisis and under-utilization of capacity of the industrial sector. The objective of growth with stability remained elusive.

In sum, in the 1970s, the average GDP growth rate was 3.6 per cent annum, ( Table 6.2) which was much lower than the East Asian growth rate (7.2 per cent), and even lower than of Latin American countries (5.2 per cent).

The approach of Fifth FYP (1974-79) was different from the earlier plans in that for the first time it laid emphasis on poverty alleviation and social justice. However, the basic framework of the plan was growth-oriented. It had contemplated a growth rate of 4.4 per cent annum and the real GDP increased by an impressive 5 per cent per annum. The increase was not steady and was marred by erratic fluctuations. The intervening years of 1979-80 registered a negative growth of 6 per cent. The plan was terminated after the third year as there was a change of government when Mrs. Indira Gandhi lost the election in 1977. This was followed by two years of Annual Plans in 1978-79 and 1979-80.

Prompted by the success of East Asian countries, some important modifications in policy with greater flexibility being given to the private sector, and free access to imports for exporters, combined with a conscious effort at managing the exchange rate to avoid exchange rate appreciation in real terms, were reflected in the Sixth FYP (1980-85). This plan had set a target of around 5.2 per cent per annum increase in GDP. Actual perceived growth rate was 5.4 per cent—the growth rate of the economy exceeded the target for the first time ( Table 6.1). The growth rate during this plan period was spurious because the base year (1979-80) rate used for the calculation was not a normal year. A recalculation using 1978-79 as the base exposes

the growth rate as 3.4 per cent per annum. This performance came from good agricultural production and particularly from rapid growth of the service sector. One of the puzzling aspects about India's growth turnaround is that it was not driven by manufactured exports, but by services sector and, therefore, has little in common with the East Asian economic miracle. However, the rate of growth of income generated in the manufacturing and mining sectors was unstable and well below target ( Mukhopadhaya, Shantakumar, & Rao 2013).

During the Seventh FYP (1985-89) period, the GDP was expected to increase at a rate of 5 per cent per annum and actual rate of growth was 5.8 per cent. In this period almost all major sectors registered satisfactory growth rates. The agricultural sector showed some improvement when compared to the 1970s and the early 1980s. The manufacturing sector also performed reasonably well and production rose at an annual rate of 6.7 per cent. Financing, transport and communications, trade, hotel and restaurants and community and personal services were other sectors in which annual growth exceeded 6.5 per cent. Thus, except for erratic performance of the agricultural sector (high growth in 1988-89 and very low growth in other years), all other sectors maintained steady growth.

The decade of the 1980s experienced an acceleration of economic growth in India compared to that experienced in the 1960s and 1970s.The most striking fact about India's growth has been the remarkable turnaround in nearly all measures of growth performance since 1980. Output per capita, output per worker, as well as total factor productivity (TFP) accelerated sharply after 1980. For example, TFP, which grew at about 0.3 per cent per annum during the 1960-80 period, grew at 2 per cent per annum in the following two decades.

A growth accounting decomposition also shows that contribution of growth of TFP to overall labour productivity growth, which was meager prior to 1980, was exceptionally high—about 60 per cent—between 1980 and 2000. Indian per capita growth since1980 has, therefore, been extensive propelled by productivity. Rodrik and Subramanian (2005) had articulated that the magnitude of performance in the aftermath of 1980s was substantial and exceeds the underperformance in the 1960-80 period, confirmed by cross-national evidence in the form of Barro-type cross-country growth experience for the periods 1980-99. Chandrasekhar and Ghosh (2002) have remarked that the stimulus for this growth came from the state as there was no sign of export promotion. Three factors were precisely responsible for this change: (1) increased government expenditure provided fiscal stimulus to

the economy; (2) the liberalization of imports induced production of luxury articles such as automobiles and electronic goods; and (3) the increased reliance on external commercial borrowing by the state in order to increase finance and remove the fiscal current account deficit.

The Seventh FYP Plan saw continued strong economic growth. However an important weakness in performance in this period was the steady increase in fiscal deficits accompanied by short–term external borrowing in an environment where export performance remained weak. These weaknesses led to a BoP crisis in1991.

Market liberalists identified three factors for these crises : (1) excessive government spending leading to a large fiscal deficit; (2) the excessive role of the government that constrained private enterprise; and (3) inadequate reforms in the external sector which did not allow India's exports to grow fast enough. Thus the government was persuaded to adopt a reform programme in July1991 in line with the Washington Consensus.

## 6.4 Reforms as Catalyst to the Growth Process

Modernization of industries was the major highlight of the Eighth FYP (1992-97). India became a member of World Trade Organization (WTO) on 1 January 1995. This Plan is attributed to the so-called model of economic development of Narasimha Rao and Monmohan Singh (The then Prime Ministers of India). The major objectives included agricultural expansion with an emphasis on rural development, containing population growth, poverty reduction, employment generation with food and nutritional security, strengthening the infrastructure, institutional building, tourism management, human resource development, involvement of Panchayat Raj, Nagarapalikas, NGOs, and decentralization and people's participation. Energy was given priority. An average annual growth rate of 6.7 per cent was achieved during this Plan period against the target of 5.6 was achieved during this plan period (Table 1). Acharya (2002) argues that India experienced one of the swiftest recoveries of economic dynamism seen anywhere in the world in the past 20 years. GDP growth was supported by export growth. there was a very rapid return of investor confidence. Inward remittances by NRIs rose from $2 billion in 1990-91 to $12 billion in 1996-97. Foreign exchange reserves exceeded $25billion by the end of 1994-95.

Jalan (1996), among many others, was skeptical about this high growth rate resulting from large capital inflows.

**Growth Stagnation during the Ninth FYP (1997-2002) :**

The Indian lumbering elephant was in sleep so far with some loss of the growth momentum in the latter half of the 1990s which coincided with the onset of the July 1997 East Asian financial crisis (which hurt exports and private capital inflows) and a sustained deterioration in the fiscal correction process, slowdown in agriculture growth and some slackening in the pace of structural reforms, that disrupted the momentum of growth. The problem was compounded by the instability inherent in coalition governments manifested in the political crisis in March 1997 as well as the economic sanctions which followed the nuclear tests in May 1998. Finally, in September 1997, the Gujarat government announced its decision on the Fifth Pay Commission report, the decisions that were to prove costly for both the fiscal and economic health of the country. In the next two years, the surge in international oil prices exerted negative effects. Finally, from the last quarter of 2000, the global economic slowdown took its toll of India's economic performance. The growth of exports slowed to below 10 percent per year in the period from 1996 to 2000. In 2000-01, renewed industrial deceleration (symptoms dissimilar of industrial deceleration that started from the mid-1960s) and virtual stagnation in agriculture pulled GDP growth down.

As the Table 6.1 shows, the rate of average GDP growth dipped to 5.35 per cent while the target was 6.5 per cent per annum. Particularly disquieting were the sharp decline in growth of agriculture and industry. The industrial sector only registered a growth rate of 5.85 per cent per annum. Indeed, the drop of GDP growth would have been much steeper but for the extraordinary buoyancy of the services sector, which averaged growth of 8 per cent during the Ninth FYP period it did not happen. This rapid growth in services was much faster than in industry, a pattern that is quite different from past experience and that raises the issue of future sustainability. By 2002, the new subsector, namely IT and BPO accounted for 2 per cent of GDP, as compared to over 50 per cent of GDP by services as a whole.

Interestingly, the GDP growth rate in the 1990s was almost the same as in the 1980s, leading some observers to conclude that the bolder market-oriented reforms of the 1990s did not really add anything to the growth that had been generated in any case by the more limited reforms of the 1980s.

**The Tenth FYP (2002-07)** aimed to transform the country into one of the fastest growing countries of the world and targeted an annual growth rate of 10

per cent per annum. Other social justice-related objectives were also proposed: reducing the poverty ratio, providing gainful and high quality employment; all children to be schooled by 2003, and all children to complete five years of schooling by 2007, reduction in gender gaps, infant mortality rate reduction, curbing population growth and to increase the literacy rate.

**Economic Growth 2003-08**

The stagnation gave way in 2003 to the most rapid growth spurt in India since independence. The year 2003 saw the economy ascend to a higher growth trajectory and the economy recorded an impressive leapfrogging growth performance (posting a GDP growth rate of 8.9 per cent per annum on the average) in the five-year period from 2002-03 to 2006-07—the highest since 1999.

Between 2002-03 and 2006-07, manufacturing grew by 8.8 %.Services grew by 9% per annum. The upsurge in industrial growth was wide- ranging across two-digit industrial groups (from textile products to basic metals, from beverages to transport equipment), This high growth was accompanied by stable prices. Merchandise and services exports in current dollars both doubled between these periods. Exports of goods and services as a proportion of GDP rose from 11.6% in1999-2000 to 20.5 % in 2005-06/. Foreign investment rose from $6 billion in 2002-03 to $20 billion in 2005-06. Remittances rose during this period by more than 7 percentage point. As on April 2007, foreign exchange reserves crossed $200 billion. Both the saving and investment rate rose to a considerable rate.

The most important causes of this exceptional economic performance in the halcyon years, 2003-2008 can be attributed due to the following factors. First, the cumulative reforms between 1991 and 2004 were absolutely crucial in releasing the country's latent dynamism and reaping the benefits of foreign trade and capital flows. Second of the prime causes for economic boom was that the government became successful in bringing about major reduction in the fiscal and revenue deficits of Central and state governments. The third one was the remarkable economic expansion of 2002-07, which vindicated the benefits of globalization by pumping up growth in many countries, including India. Fourth, for a change, India embraced the global services boom, racking up rapid growth not just in software exports but in a wide range of services, including telecom, media, finance, and retail. Last, but by no means least, India's excellent macroeconomic performance was nurtured by the exceptionally deft exchange rate management and monetary policy conducted by the RBI in unusually challenging circumstances.

After this excellent performance, the economy was hard hit by the global financial crisis, unleashed in US subprime- mortgage market. The damage from global recession was substantial. In the first half of FY 2008-09, the growth of the India economy had slowed down to 7.5 per cent. Following the global credit crunch of September economic activity decelerated sharply. Merchandise exports fell by 12 per cent. Industrial growth turned negative in October for the first time in over 15 years. The rupee had depreciated by 20 per cent. The forex reserves were down by over $60 billion since March. however, during this 10th FYP the achieved growth rate was 8 per cent per annum (Table 6.1).

Encouraged by the performance in the Tenth Plan, a target of 9.5 per cent growth was set for the Eleventh FYP (2007-12) and the Planning Commission also called for growth to be more inclusive. India started this plan from a relatively high basis because of progress achieved in many sectors of the economy, possibly due to the rising middle classes and entrepreneurs, along with the reforms and a more pragmatic approach in planning, including the Private-Public Participation (PPP) projects. The emphasis and upgrading on agriculture and infrastructure facilities (electric powers, roads, ports, airports, railways, and so on) after decades of neglect, is one of the major features of this Plan, though the achievement in increasing agricultural GDP growth was very poor (less than 2 per cent as against the target of 4 per cent growth in agriculture). To improve health and education especially in the rural areas by the government is no less important. While the Plan focuses on the public sector, the private sector is expected to play an increasing role in agriculture, industry and services sectors. The Deputy Chairman of Planning Commission of India has indicated that the macroeconomic requirements for 9 per cent growth are challenging but not impossible. The performance of the economy in the Eleventh FYP period looks to achieve an average of 9 per cent— a remarkable achievement given that this was a period when the world economy was hard hit by a crisis of exceptional variety. For example, following the global crisis in 2008-09, the growth rate fell sharply to 4.15 per cent. However, in the following two years 2009-10 and 2010-11 there was a remarkable recovery, with GDP growing at rates that were unprecedentedly high (8.4 per cent in 2009-10 and 10.3 per cent in 2010-11) (Table 6.2)

The year 2011-12 was exceptionally a bad year for India in terms of its growth in real GDP. The reasons for the slowdown lies in global factors, particularly the crisis in eurozone area and near-recessionary conditions prevailing in Europe, sluggish growth in many other industrialized countries, stagnation in Japan, and hardening international prices of crude oil. Domestic factors, viz., the tightening

of monetary policy resulted in slowing down of investment and growth, mainly in the industrial sector.

In sum, in the nine years between 1991-92 and 2000-01 the economy grew at 6.1 per cent per annum—the fastest decadal growth in India's recorded history. But overall, between 1992-93 and 2011-12 (a time-span covering two decades), the growth rate in terms of GDP at factor cost (at 2004-05 prices) has been over 6 per cent in as many years as 14 years. Clearly, during this period of over the last two decades, the services sector, such as IT and financial services being the principal source of employment in urban areas, accounting for 582 of every 1,000 persons employed in urban areas has emerged as the key driver of growth (9.6 per cent) in the Indian economy, going ahead of agriculture (4 per cent) and industry (8.0 per cent). In 2011-12, the growth rate of services has been placed at 9.4 per cent.

The twin objectives of India's Twelfth FYP (2012-17) are ensuring food security and improving the lot of farmers through higher investments in agriculture and allied sectors. The happy mirror objectives of 12th FYP soon faded out because the planning era ended with the advent of a Government of India policy think-tank called Niti Aayog starting from 1st January 2015, established by our Honourable Prime Minister Sri Narendra Modi, after dissolving the Planning Commission, and the 12th FYP—a phase with many objectives with campaign for Make in India, Skill India, Digital India, Startup India and Pradhan Mantri Jan Dhan Yojana and the earlier objectives were not put in proper place. In the growth front, the growth rate has remained rather subdued since 2010-11. At the moment the growth rate (6.8 per cent for 2016-17) remains not only by far lower than the high point of 10.3 per cent (achieved in 2010-11) but also significantly lower than the average growth rate of 8.4 per cent of the period 2003-04 to 2010-11.

**Table 6 1: Growth Performance of the Indian economy in the Five Year Plan**

(% per annum)

| Plan Period | Target | Realization |
|---|---|---|
| 1. Eighth Plan (1992-96) | 5.6 | 6.7 |
| 2. Ninth Plan (1997-01) | 6.5 | 5.35 |
| 3. Tenth Plan (2002-06) | 10 | 8 |
| 4. Eleventh Plan(2007-11) | 9.5 | 9.0 |

Source : Eleventh Five Year Plan 2007-2012

The Plan-wise economic growth path of India reveals the following: at least until the Ninth FYP, India's GDP growth had suffered from instability and fluctuating agricultural production; the attention and investment in agriculture under various Plans had not made any significant impact on the uncertainty in agriculture. Although average annual growth rate of national income declined almost by 1 per cent in the Ninth Plan, the Tenth Plan and the Eleventh Plan struck a highest-ever growth rate as is evident by Table 6 1.

Of late, there has been lackluster performance by the Indian economy in respect of growth. Possible reasons behind it are not far to seek :

After 2011, a combination of external and internal factors led to an end to the dream run. On the one hand, the fast rise in oil prices in the global economy together with the sharp rise in food prices caused by supply-side factors operating in the agricultural sector resulted in a high rate of inflation and forced the Reserve Bank of India to follow an unusually hawkish monetary policy. On the other hand, encouraged by the unusual investment exuberance of the earlier phase, the government ushered-in a fiscal consolidation programme, leading to sharp cutbacks in government expenditure. The resulting fall in public investment hit the agricultural sector particularly badly. It was the combination of all these factors that brought the high growth phase of the Indian economy to an end after 2011 ( Rakshit, 2017). It was now obvious to the private investors that in such a scenario it was unrealistic to expect aggregate demand to continue to increase. A phase of investment deceleration ensued.

**Table 6.2 : The Growth Rate of the Indian Economy : A Long View**

| Period | Growth Rate |
|---|---|
| 1951 – 2 to 1960 – 1 | 3.8 |
| 1961 – 2 to 1970 – 1 | 3.5 |
| 1971 – 2 to 1980 – 1 | 3.6 |
| 1981 – 2 to 1990 – 1 | 5.2 |
| 1991 – 2 to 2000 – 1 | 6.1 |
| 2001 – 2 | 5.8 |
| 2002 – 3 | 3.8 |

| Period | Growth Rate |
|---|---|
| 2003 – 4 | 8.5 |
| 2004 – 5 | 7.5 |
| 2005 – 6 | 9.5 |
| 2006 – 7 | 9.7 |
| 2007 – 8 | 9.0 |
| 2008 – 9 | 4.15 |
| 2009 – 10 | 8.50 |
| 2010 – 11 | 5.24 |
| 2011 – 12 | 5.46 |
| 2012 – 13 | 6.39 |
| 2013 – 14 | 7.40 |
| 2014 – 15 | 8.00 |
| 2015 – 16 | 8.26 |
| 2016 – 17 | 6.80 |
| 2017 – 18 | 6.53 |
| 2018 – 19 | 4.40 |
| 2019 – 20 | –7.96 |

Source : Economic Survey, Various issues.

In what follows is that India's pattern of growth of agriculture- industry – services sequencing is unique. Instead of becoming an industry based economy, India has jumped over it and has transited to post-industrial service economy. The factors responsible for the rapid growth of the services sector are identified as: (i) with the economic growth and industrial development, demand for services like transport, communication, electricity, storage, finance, etc. has increased tremendously leading to the expansion of the services or the tertiary sector; (ii) rapid development of Information Technology services has proved to be a great source of expansion for the communications sector; (iii) defense, civil administration, economic and social services like health and education have also made a huge contribution for

the growth of service sector; and (iv) due to increase in the disposable income of the large middle class section, demand for services like hotels and restaurants, transport, communication, etc. have increased.

The entire declining share of agriculture in GDP (from 53.1 percent in 1950-51 to only 13.9 percent in 2011-12, and further rise to 17.5 per cent in 2014-15 ( at 2011-12 prices) has been absorbed by services or tertiary sectors Here the data from 1960 to 2010-11 is expressed at 2004-05 prices.

On the other hand, over the planning period, manufacturing which has been observed historically to be the main contributor of growth has played only a minor role in India. The share of industries in GDP has remained stagnant at around 27 percent (in 2004-05 prices) since 1991. In particular, it remained staying in the range of 23-26 per cent during 1980-81 and 2010-11. However the contribution of this sector slightly picked up in the years 2013-14 and 2014-15 when estimated at higher base prices of 2011-12.

But there has been an India's excess growth of service sector from 30 percent of its share in GDP in 1951 to 59 percent in 2011-12. However, the contribution of this service sector shows a decline towards GDP after 2011-12. It declines to 49.6 per cent in 2013-14 at 2011-12 price level, but it rose to 50.7 per cent in 2014-15 at the same 2011-12 prices. This episode belies historical theory of development. That is why the World Bank did not hesitate to say that this was India's services revolution.

## 6.5 Conclusion

The crisis of 1991 led the Indian policy makers to think beyond the policy of import substitution to outward oriented export promotion model. The Indian economy was integrated with the economies of the world. Reforms were initiated in industrial policy & foreign investment policy, trade & exchange rate policy, tax reforms, public sector policy, financial sector reforms, reforms in agricultural sector, labor market reforms and others. The results of these reforms were seen soon after the reforms. The liberalization of the Indian economy has helped to put her on a higher growth trajectory. The GDP growth rate which was merely 1.43 per cent in 1991-92, increased to 5.36 per cent in 1992-93 and 6.53 per cent in 2017-18.

Gone are the days when the Indian lumbering elephant was all along on a broken and fluctuating track and slept like Rip Van Winkle with some losses of

the growth momentum particularly in the Hindu growth period and in the latter half of the 1990s and after the global tsunami in 2007-08 and Euro zone crisis period in 2010-11. Now she is an 'awakening giant' with services sector making rapid strides and emerging as the largest contributor to GDP. With a turn towards free market and open trade, she has placed herself as one of the fastest growing economies of the world and is making striking progress in its contribution to the global growth of GDP. The country's external sector performance has improved post-liberalization with an increase in FDI flows. Her share in world GDP has also increased from an average of 4.8 per cent during 2001-07 to 6.1 per cent during 2008-13 and further to 7 per cent during 2014-15. Indian economy has fared much better among the BRICS economies. Still there are many minus points and downsize risks that continue to linger on the horizon. It has been well documented that India's overall productivity growth after 1991 has been very slow, especially when compared to People Republic of China. Interstate disparities in the growth rate of SDP and per capita SDP has increased sharply after 1991. Besides, risks are awaiting in its good performance in growth front, among others, include the continued sluggishness of the global economy, possible capital outflows consequent upon the recent increase of interest rate in the USA, a possible increase in the global oil price in the future, the problem of inadequate monsoon failure and financial market vulnerabilities.

## 6.6 Summary

**Hindu rate of growth :** From 1950 to 1980, Indian real gross domestic product (GDP) grew at an annual average rate of 3.5 % (1.5% in per capita terms). This is called by Raj Krishna as a Hindu rate of growth. It is called so because it has not altered due to drought, flood, war, and political stability over the years.

**License-Permit Quota Raj :** a Phrase used to describe the system of allocating industrial permits to expand or initiate production ventures under government regulations, a process that has been highly politicized, bureaucratized, and much derided. Raj is the Hindi word for "rule" or "sovereignty"

**Stabilization and Structural Adjustment :** Conceptually, the economic reform agenda can be divided into two strands—stabilization, aimed at redressing the internal and external imbalances in the economy, and structural adjustment aimed at removing the rigidities and inefficiencies in the system and improving its competitiveness. Stabilization is macroeconomic in content while structural adjustment encompasses both micro and macroeconomic aspects.

## 6.7 Exercises

**A. Short-answer type questions**

1. What is Hindu rate of growth ? Why is it called so ?
2. Why is it so that the actual performance was disappointing during India's third plan (1960-66) ?
3. What is meant by stabilization and structural adjustment ?
4. The year 2011-12 was exceptionally a bad year for India. Do you Agree ? Give reasons for your answer.
5. Identify three factors that led to the crisis of 1991.

**B. Medium-answer type questions**

1. In the words of Raj Krishna: "For 32 years covering the period of the first three decades of India's development planning, the rate of growth of national income has been stagnating around a miserable mean of about 3.5 per cent. This rate keeps India as low as 71st in the list of 104 countries ordered according to the rate of growth of income per capita". In the light of the above statement, state what the result was in this context.
2. What changed in the 1980s in the Indian economy were three things? What are they and with outcomes ?
3. What compelled India in the early 1990s to seek and to take out a $1.8 billion from the IMF and to introduce macroeconomic stabilization and structural adjustment measures?
4. What were the factors responsible for the rapid growth of the services sector?
5. What explains India's outstanding macroeconomic performance in the halcyon years, 2003-08

**C. Long-answer type questions**

1. Highlight the dynamics of seven decades of India's growth experience: from Hindu rate to high growth.
2. Do you think the economic reforms act as catalyst to the Indian growth process? Explain.
3. "India's GDP growth performance did not improve significantly during the

1990s as compared to the 1980s, but the post-1980s growth marks a significant departure from its past performance". Justify the statement with appropriate facts.

4. "India's GDP growth improved from the Hindu rate of 3.5% till the 1970s to above 9% a few years back accompanied by significant changes in structure."

   In the light of the above, briefly highlight (a) the key features of India's growth trajectory since the 1950s; (b) Does the recent growth history suggest a service-led growth; and (c) what, according to you, are the important factors accounting for the step in growth since the 1990s.

5. Read the following Table and answer the following questions :

Table : GDP growth and Total Factor Productivity Growth (TFPG) (%)

| | 1970-71 to 1980-81 | 1980-81 to 1990-91 | 1990-2004-05 |
|---|---|---|---|
| GDP at factor cost | 3.44 | 5.51 | 5.92 |
| Sectoral Contribution in GDP growth in Agriculture etc. | 0.67 (1.6) | 1.07 (3.13) | 0.69 (2.54) |
| Industry (similarly) | 1.01 (4.44) | 1.81 (6.90) | 1.62 (6.04) |
| Services (similarly) | 1.65 (4.64) | 2.71 (6.88) | 3.66 (7.99) |
| TFPG | 0.7 | 2.0 | 2.6 |
| Proportion of GDP growth explained by TFPG | 20.8 | 37.7 | 39.7 |

Note : Figures in the parenthesis denote sectoral average GDP growth.

(a) From the above Table briefly comment on the growth process in the Indian economy. Do the periodisations observed in the table coincide with the structural breaks observed in the economy?

(b) What according to you has contributed to the step up in GDP growth: higher growth of services or improved efficiency? Justify.

(c) What explains the observed surge in productivity growth in the economy since the 1980s?

## 6.8 References

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