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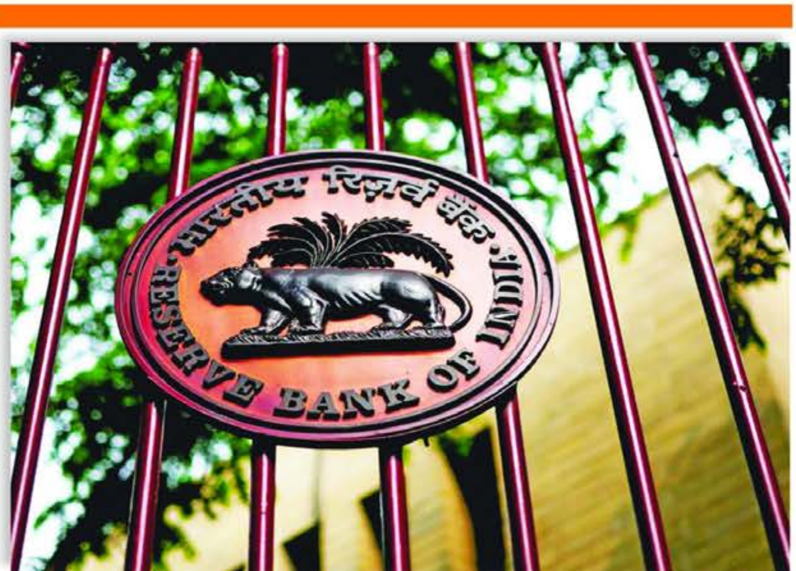
Indian Economy – I



INDIAN ECONOMY - I

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Background

Traditionally the role of the government administration was confined to certain essential services like defence, law and order, etc. With independence, the Indian government has launched a process of planned economic and social development towards the improvement of living standards.

In this process private sector activities in many areas were regulated, and the government itself became one of the economic agents by establishing many commercial and industrial enterprises. The enormous pressure on the system and the change in the global economic environment has led to economic reforms.

The economic policy reforms focussed at redefining the role of government administration through dismantling the regulatory framework in many economic sectors. The aim is to integrate the Indian economy with the global economy for efficient use of available natural and human resources.

Several economic reform measures got initiated during the 1980s with exchange rates adjusting continually for differences in the inflation rates, change in the approach of monetary policy to monetary targeting, instituting new institutions in the financial sector, announcement of long-term fiscal policy, reducing quota requirements in selected commodities, focusing on telecom & information & technology sector, etc.

Planning and Economic Reform

State led planning and state control over the economy was seen as a way ahead by most of the newly independent countries. India also adopted the state led planning model based on the lines of the USSR. For a significant period of time, Economic policy in India was guided by 5-year plans. A major shift in policy from agriculture towards industry and then once again to agriculture due to the food crisis and other geopolitical implications, were some striking features of the state controlled economy in India.

Washington Consensus (Complete Privatisation) and Economic Reform

- Till the late 1970's world had recognised the limits of a state dominated economy, thus market, i.e., the private sector, was promoted emphatically. Many countries shifted their economic policy, arguing for a minimal role of the government in the economy.
- Such a development strategy was regarded as being inspired by the Washington Consensus. This consensus is a set of economic policy prescriptions directing 'economic reform'. The prescriptions are composed of policies in areas such as macroeconomic stabilization, opening economy with respect to both trade and investment, and the expansion of market forces within the domestic economy.
- The term, 'Washington Consensus' usually refers to the level of agreement between the International Monetary Fund (IMF), World Bank, and U.S. Department of the Treasury

on policy recommendations. All shared the view, typically labelled neoliberal, that the operation of the free market and the reduction of state involvement were crucial to development in the global South.

Mixed Economy and Economic Reform

By the mid-1990s, it was significantly comprehended that neither the Washington Consensus (complete privatisation) nor the state-led planned economic model were the best strategies of development. Thus, the focus shifted to a decent blend of both the socialist and capitalist model, i.e., mixed economy model.

The Macroeconomic Crisis

- Macroeconomic crisis is a situation in the economy experience a falling GDP, a drying up of liquidity and rising/falling prices due to inflation/deflation etc.
- Although the Indian economy grew more swiftly during the 1980s than it had during previous decades, the proportion of the central government's fiscal deficit grew over the decade as well. By the mid-1980s, the fiscal deficit was approximately 8% of GDP, and it continued at that volume through the remainder of the 1980s. Inflation also grew over the course of the 1980s, and stood at 10% at the start of the 1990s.
- The public sector continued to absorb much of the country's investment capital without contributing to the economy proportionately. Iraq's invasion of Kuwait in August 1990 and the ensuing Gulf War strained the economic conditions.
- The World Bank pronounced that India, along with several other South Asian and East Asian countries, was among the most adversely affected due to the escalation in oil prices, loss of foreign exchange earnings of workers in the Gulf region, displaced workers, and a reduction in export profits.
- During the mentioned crisis, India found itself with foreign exchange reserves adequate to finance only two weeks of necessary imports, a lowered investment rating that made additional loans costlier, and the prospect of defaulting on its international debt payments.The immediate task of the government was to re-establish macroeconomic stability, prevent a default on debt payments, and bring down inflation, all of which the government accomplished despite being one of the most fragile governments since independence.

Mandatory Reform

Under the Extended Fund Facility (EFF) programme of the IMF, countries get external currency support from the fund to mitigate their BoP crisis, but such supports have some obligatory terms put on the economy to be fulfilled. The IMF conditions for India during the 1980s BoP crisis were:

- Devaluation of the rupee by 22% (21 to 27 per $).
- Drastic reduction in the peak import tariff from the prevailing level of 130% to 30%.
- Excise duties to be hiked by 20% to neutralise the revenue shortfalls due to the custom cut.
- All government expenditure to be cut down by 10%, annually.

Macroeconomic Reforms

In response to the internal economic crisis of 1990–91 and the changing international situation, the Narasimha Rao government decided to introduce economic reforms or the

New Economic Policy (NEP). The NEP clearly reflected certain global trends, like the collapse of the socialist economy and growing acceptance of economic globalization across the world.

Although the reforms as a part of the process of liberalization and globalization were revolutionary in nature, these were launched within the democratic framework of the country. They marked a shift from the Nehruvian consensus of the 1950s to a new consensus around reforms.

The reform programme consisted of macroeconomic stabilization and structural reforms. Macroeconomic stabilization is a short term programme to overcome the macroeconomic crisis by regulating the total demand in the economy while structural reform was a medium- and long-term programme, it dealt with sectoral adjustments and the problems on the supply side of the economy by bringing in the dynamism and competitiveness to the economy. Structural reforms included liberalized trade and investment policies with emphasis on exports, industrial deregulation, disinvestment and public sector reforms, and reform of the capital markets and the financial sector. Focus areas of 1991 Economic Reforms were LPG:

- L – Liberalization (Reduction of government control)
- P – Privatization (Privatization is the transfer of control of ownership of economic resources from the public sector to the private sector)
- G – Globalisation (It means integration of the national economy with the global economy).

Liberalisation

Foreign Exchange Reforms

- The first important reform in the external sector was made in the foreign exchange market. In 1991, as an immediate measure to resolve the balance of payments crisis, the rupee was devalued against foreign currencies.
- This led to an increase in the inflow of foreign exchange.

Deregulation of Industrial Sector

- Regulatory mechanisms in India were enforced in various ways, i.e., industrial licensing under which every entrepreneur had to get permission from government officials to start a firm, close a firm or to decide the amount of goods that could be produced, the private sector was not allowed in many industries, some goods could be produced only in small scale industries etc.
- The economic reforms introduced in and after 1991 removed many of these restrictions. Industrial licensing was abolished for almost all but product categories — alcohol, cigarettes, hazardous chemicals, industrial explosives, electronics, aerospace and drugs and pharmaceuticals.
- Many goods produced by small scale industries have now been dereserved. In many industries, the market has been allowed to determine the prices.

Financial Sector Reforms

- Financial sector includes financial institutions such as commercial banks, investment banks, stock exchange operations and foreign exchange market. The financial sector in India is controlled by the Reserve Bank of India (RBI).
- One of the major aims of financial sector reforms is to reduce the role of RBI from regulator to facilitator of the financial sector.
- Foreign Institutional Investors (FII) such as merchant bankers, mutual funds and pension funds are now allowed to invest in Indian financial markets.

Tax Reforms

- Tax reforms are concerned with the reforms in government's taxation and public expenditure policies which are collectively known as its fiscal policy.
- Since 1991, there has been a continuous reduction in the taxes on individual incomes as it was felt that high rates of income tax were an important reason for tax evasion.

Trade and Investment Policy Reforms

- India was following a regime of quantitative restrictions on imports through tight control over imports and by keeping the tariffs very high. These policies reduced efficiency and competitiveness which led to slow growth of the manufacturing sector.
- The trade policy reforms focused at dismantling of quantitative restrictions on imports and exports, reduction of tariff rates and removal of licensing procedures for imports.
- Import licensing was abolished except in case of hazardous and environmentally sensitive industries.
- Export duties have been removed to increase the competitive position of Indian goods in the international markets.

Privatisation

- Privatisation is the transfer of control of ownership of economic resources from the public sector to the private sector.
- Disinvestment is selling off part of the equity of PSUs to the public.

Globalisation

- Globalisation is the outcome of the policies of liberalisation and privatisation.
- It is generally understood to mean integration of the economy of the country with the world economy.
- It involves creation of networks and activities transcending economic, social and geographical boundaries.
- It is a process of turning the world into one whole or creating a borderless world.

Outsourcing

- In outsourcing, a company hires regular service from external sources, mostly from other countries, which was previously provided internally or from within the country (like legal advice, computer service, advertisement, security — each provided by the respective departments of the company).
- This is one of the important outcomes of the globalisation process.

World Trade Organisation (WTO)

- It is a precursor organisation for promoting globalisation and integrating the local economy with the global economy.
- The WTO was founded in 1995 as the successor organisation to the General Agreement on Trade and Tariff (GATT).
- WTO is expected to establish a rule based trading regime in which nations cannot place arbitrary restrictions on trade.
- The WTO agreements cover trade in goods as well as services to facilitate international trade (bilateral and multilateral) through the removal of tariff as well as non-tariff barriers and providing greater market access to all member countries.

Indian Economy Since Reforms

- The economic reforms, have led to considerable liberalization and freeing of international trade, and to some replacement of what used to be called the 'Licence Raj' (with pervasive bureaucratic control over private economic initiatives). This has greatly added to business opportunities in India and has also helped to consolidate India's faster economic growth.
- Liberalization has helped to free Indian entrepreneurs to seek global trade, and the success has been especially large in specific sectors such as information technology.
- The telecom sector is a success story of India's economic reforms. The telecom sector underwent a revolution in the Indian-growth story. 'The rate of growth of GDP from telecom accelerated from an average of 6.3% per annum (during 1980–81 to 1991–92) to 18% per annum during 1992–93 to 2002–03.
- In the case of ports, private operators have been introduced and then the Tariff Authority of Major Ports was formed; in the civil-aviation sectors, new private airlines, new private airports and the beginning of an open skies policy are evident.
- Relaxed entry of foreign firms in the services sector was also directly attributable to the growth in the services sector as the share of services in foreign direct investment increased. Due to economic reforms, the tertiary sector has been the main gainer of the shift in employment. Yet the increase in its employment share has not been in accordance with the increase in its share of GDP.
- The share of secondary sector in employment has increased at a relatively faster rate while its share in GDP has remained constant at around 25%. The economic reforms were more radical as far as industries were concerned. Changes in the policy framework gave a big boost to industries. The major reforms were the abolition of licenses for a wide range of industries. Licenses are now only required for some industries.
- The economic reforms have also contributed to the rise in competition among states to attract private investment. This has promoted the feeling of cooperative federalism.

Other Positive Impacts of Economic Reform

- The growth of GDP increased from 5.6% during 1980-91 to 6.4% during 1992-2001.
- Foreign investment increased.
- Foreign exchange reserves increased.
- Growth of service sector has increased.

- The economic reforms in India since 1991 have also brought changes in trade and industrial policies which has led to competition for production with cheap labour, which led to a reduction in cost of production.

Negative Impacts of Economic Reform

- Basic problems of employment, agriculture, industry, infrastructure development and fiscal management could not be solved through New Economic policy (NEP).
- The agricultural growth decelerated in the economic reform period (commencing in 1991). Between 1991 and 2016, agricultural growth has stagnated at around 1%. The rate of growth of production of food grains fell from 2.9% per annum in 1980s to 2.0% per annum in 1990s and stood at 2.1% per annum in the first decade of the 21^{st} century.
- Since the Economic Reform of 1991, both public sector and private sector firms are downsizing workers with greater pace, there is subcontracting and outsourcing of the work which has also added to informal sector employment.
- FDI attracted towards industrially developed States like Gujarat, Maharashtra more than under-developed States like Jharkhand, Orissa. Hence it has led to regional disparity.

Redefining the Role of the State vis-à-vis Economic Reform

- The adoption of the NEP (New Economic Policy) based on liberalization and privatization has given rise to a debate on the nature of the link between state and market.
- The NEP does not imply a retreat of the state. The state and the market are not substitutes for one another, but they complement each other. Further, these two actors provide mutual checks and balances in such a way that one can correct the failures of the other. The state needs to formulate policies to bring about improved transparency and greater accountability, which forms the basic pillars of good governance.

India vs China

- **1978 China's Economic Reforms:** Agriculture was transformed first and then reforms were taken to the industrial sector. China's economic growth has also benefitted from a very large net inflow of foreign direct investment, a sign of confidence in the Chinese economy by outside investors.
- The overall performance of the Indian economy may not have matched that of post-reform China (with its sustained growth rate of 8 to 10% a year), but India's move from the rigid box of a 3% growth rate to the 5 to 8% arena is certainly not a negligible development.
- India's reduction of poverty has been far less rapid than what has occurred in China since the economic reforms.

Economic Reforms and Vulnerable sections

The proportions of the Indian population with incomes below the standard poverty lines have fallen over the 1980s and 1990s.

Economic Reforms enabled greater access to technological advancements in agriculture, including high yield varieties, genetically modified crops (GM crops) and micro irrigation techniques. Foreign investment in agriculture in contract farming, cold storage and food processing have helped farmers. Access to foreign markets has greatly boosted Indian agricultural exports.

Period after Economic Reform has also been marked by an increase in the level of inequality in the country. According to a study 'In both the early 1990s and the early 2000s, the wealthiest 10% of wealth-holders held at least 50% of total assets, while the least wealthy 10% held at most 0.4% of total assets. In case of land, it is more unequally distributed than wealth.

After the new economic reforms, the trade unions in the country have lost their edge and militancy sprit to sustain the workers' rights and further the size of the trade unions has also reduced and is not able to maintain pressure on the government. The Central trade unions did not perform an effective role for the informal sector workers, rather they never considered them as workers. Today organised sector workers are also struggling to retain existing rights.

Unsustainable agricultural practices post-economic reform and the inability to compete against cheaper imports contributed to the distress migration of rural farmers, destroying rural agrarian societies and traditional family structures. The dependency of MNC seeds resulted in farmers losing touch with indigenous seeds and farming methods.

The Next Round of Reforms

Three generations of reforms as a way forward to 1991 reform have been announced till date, although some experts have suggested the fourth generation, too.

First Generation Reforms (1991–2000)

- Reforms undertaken from 1991 to 2000 are called by the government as the reforms of the First Generation. The features of the first generation of Reform were:
  - **Public Sector Reforms:** To make the public-sector undertakings profitable and efficient, disinvestment was done.
  - **Promotion to Private Sector:** 'Dereservation' and 'Delicencing' of the industries, abolition of the Monopolies and Restrictive Trade Practices (MRTP) limit.
- Other reforms undertaken during the first generation of reforms:
  - External Sector Reforms
  - Financial Sector Reforms
  - Tax Reforms

Second Generation Reforms (2000–01 Onwards)

Reforms of the 1990s were not effective enough, so another set of reforms were required. These reforms were not only deeper and delicate, but required a higher political will power from the governments. The features of such reforms are:

- **Public Sector Reforms:** Greater functional autonomy, freer leverage to the capital market, international tie-ups and greenfield ventures, disinvestment etc.
- **Factor Market Reforms:** It consists of dismantling of the Administered Price Mechanism (under this government predetermined prices on the basis of a derived formula). Petroleum sector has also been opened to private investment.