CHAPTER I

INTRODUCTION

“The world has narrowed to a neighbourhood before it has broadened into a brotherhood”.

- Lynclon B. Johnson

For decades, India’s external payments position has been under strain, punctuated by a number of episodes of extreme crisis when the country lived a hand to mouth existence. After the broad based reforms undertaken since 1991, the external sector is, in a sense, the true success story of Indian economic reforms.\(^1\) External sector is devoted to the policy changes in the field of both current account and capital account transactions, more especially foreign trade, foreign investment inflows, forex reserves, external debt and the country’s overseas investment.\(^2\) Prior to mid-1991, foreign trade of India suffered from strict bureaucratic and discretionary controls. Similarly, the Government of India and the Reserve Bank of India, tightly controlled foreign exchange transactions.


At the beginning of mid-1991, the Government of India has introduced a series of reforms to liberalize and globalize the Indian economy. A reborn in the external sector of India is intended to integrate the Indian economy with the world economy. In this context, it is observed, “The process of globalization is a reality which cannot be denied and also should not be avoided. However, it needs to be managed, so that we can derive the maximum advantage from World markets”.

**Meaning of External Sector**

The external sector comprises of basic economic variables that have an influence on economic growth and development. These variables are:

- Balance of payments
- Current account
- Capital account and financial account
- Foreign direct investment
- Portfolio investment
- Other investments
- External debt
- Average exchange rate of private external debt
- Debt service
• Reserve assets
• International investment position
• Export price index and import price index

External Sector Reforms in India

To overcome the balance of payments crisis 1991, and restore economic health to the external sector, various measures of stabilization and structural reforms were undertaken by the new Congress Government with Dr. Manmohan Singh as the Finance Minister. They are briefly given below:

Devaluation of Rupee

Before 1991, the Indian Rupee was overvalued in terms of US $ and other important currencies. This overvaluation of the Indian Rupee discouraged our exports and encouraged imports. This foreign exchange policy had therefore anti-export bias. To discourage imports and encourage exports, rupee was devalued on July 1, 1991 and again on July 3, 1991. In the two doses of devaluation, the rupee value in terms of trade-weighted basket of foreign currencies declined on an average by 22.8 per cent. The devaluation of the rupee in July 1991 was followed by the withdrawal of cash compensatory subsidy to exporters, which prevailed before. Thus,
devaluation was expected to act as a substitute of export subsidy as the exporters would get more rupees in exchange of foreign currencies.

**Trade Liberalisation and Reduction in Customs Duties**

An important aspect of external sector reform has been to open up the Indian economy to global trade. In the place of import-substitution, export-led growth strategy has been adopted. Towards that end, customs duties on non-agricultural imports have been reduced, so that domestic industries should get cheaper imported raw materials and capital goods, to produce goods for exports at lower prices. Accordingly, the peak customs tariff rate, which was over 300 per cent in 1990, was reduced in a phased manner to 35 per cent in 2002-03 budget and further to 15 per cent in 2005-06 and to 12.5 per cent in 2006-07 budget. Customs duties on imports were lowered not only to increase the competitiveness of Indian exports but to serve other purposes. It checked cost-push inflation which arose due to devaluation of India rupee.

**Assistance from IMF and World Bank**

To overcome the balance of payments problem, an emergency measure taken was to obtain financial aid from IMF and World Bank. IMF
agreed to provide aid only, if India fulfilled its preconditions. Its preconditions were that we should devalue our rupee, liberalise imports by lowering customs duties and introduce structural reforms by undertaking various measures of domestic liberalization and opening up the Indian economy to foreign trade and investment. India accepted these conditions and got assistance from IMF.

**Cut in Fiscal Deficit for Macroeconomic Stabilisation**

Rising fiscal deficit in the eighties was an important cause of worsening of the balance of payments. Therefore, an important measure taken to tackle the problem of balance of payments was to reduce fiscal deficit.

**Switch-over to Market-determined Exchange Rate**

An important measure adopted to tackle the balance of payments problem was that after a two-year transition, exchange rate was made market determined with effect from 1993. With this, exchange rate began to be determined by demand for and supply of foreign currencies and Indian rupee. The Indian rupee was made convertible on current account
transactions. This facilitated the foreign exchange transactions as the exchange rate determined by market forces.

**Elimination of Anti-Export Bias**

An important reform in the external sector was change in India’s trade policy, which had anti-export bias and pro-import-substitution bias. The new trade policy was to lower customs duties so as to reduce protection to large-scale industries. Protection reduces productivity and efficiency through eliminating foreign competition. To remove the pro-import-substitution bias and liberalise imports, in 1992-93 the peak custom duty on imports was reduced from 150 per cent to 110 per cent. The maximum import duty was further reduced to 85 per cent in 1993-94, to 65 per cent in 1994-95, to 50 per cent in 1995-96 and to 45 per cent in 1997. It is further liberalized and now it is around 10 per cent only.

**Background of Economic Crisis**

India started its economic planning in 1950s. Our plan objectives were: sustained economic growth, self-reliance, better income distribution and alleviation of poverty. We adopted the socialistic economic policy to attain these objectives. As per the pursued policy, capital intensive and
major industries were reserved to public sector and the rest were opened to private sector. Public sector received the priority and prominence in allocation of resources. Our country preferred the policy of controls, licensing and restrictions in giving permission to private sector and foreign investors. The framework of other policies like taxation, fiscal and monetary policy, foreign exchange policy and industrial policy were in line with the above strategy. This is called “Closed Economy” approach. The policies mentioned above suited well during the initial years of planning. However, their efficiency was lost thereafter. Our economic growth was slow and our problems started aggravating due to many reasons. Things went wrong because, we continued to cling on to policies and institutions long after they served their purpose. Other developing countries like Japan, China, Thailand, Korea and Indonesia liberalized their economies to global investments, competition and adopted global technologies. These countries achieved faster growth and prosperity. India lost the opportunity of faster growth due to not adopting alternate policies.³ The global development experience of the last few decades show that a policy with fewer barriers

and restrictions can bring faster industrialization, export growth and sustainable economic growth.

Though late, India looked for alternate economic policies during 1980’s, it was Mr. Rajiv Gandhi the then Prime Minister who first initiated economic reforms in our country. However, these policies were half-hearted and policy changes were not comprehensive. In the early 1991, India faced a major economic crisis, which was, according to most of the economists, considered as the worst that the country had experienced since independence. This crisis is not as yet over inspite of all the bold claims made by the government. The crisis did not develop suddenly. It was accumulated over several years. In fact, the origin of crisis was due to the cavalier macro-management of the economy during the 1980’s which led to the large and persistent macro-economic imbalances.

The strategy of development, not withstanding its limitations, cannot be blamed for this crisis. There were many factors responsible for this crisis. For example, the government’s revenue deficit (excess of expenditure over revenue) was increasing leading to fiscal deficit (excess of total receipts over total expenditure) and the government’s internal and external borrowing increased considerably.
Further, the steadily growing gap between the income and expenditure of the economy as a whole resulted in large current account deficit in the balance of payments, which has to be financed by borrowing from abroad on a large scale. Because of the absence of prudent macro-management of the economy, both the types of imbalance—internal imbalance in the fiscal situation and external imbalance in the balance of payments situation had to be faced by the economy.

Because of these imbalances, the economy was pushed into a deep economic crisis. The Gulf crisis that occurred in the late 1990 sharply accentuated macro-economic problems of the country. There was also political instability in the country at this time.

All these developments together eroded the international confidence in the Indian economy and this resulted in a steep decline in the country’s credit-worthiness in the international capital market. However, it should be noted that the problems of the economy did not assume crisis to a large proportion abruptly. In fact, these problems had been accumulated over

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several years, particularly after 1980. These problems had practically destroyed the capacity of the Indian economy to cope with an internal or external shock. In the 1970s (i.e. period from 1970 to 1979), the Indian economy was strong enough to bear even much larger shocks but, it was during the 1980s (i.e. during the period from 1980 to 1989) that the economy was pushed into severe crisis and by the year 1990, the situation worsened to such an extent that the economy could not bear even minor oil shocks which caused disproportionately large impact and a macro economic crisis eroded in the form of unsustainable fiscal and current account deficits and accelerated inflation.

Thus, in 1990-91, the crisis situation had worsened. In response to this crisis, the government decided to introduce economic reforms consisting of two strands-macro-economic stabilization and structural reforms. While stabilisation deals with demand management, structural reforms deal with sectoral adjustments designed to tackle the problems on the supply side of the economy.

**Economic Reforms and External Vulnerability**

The liberalizing economic reforms of the 1990s were explicitly determined by the performance of the external sector. To begin with, the
crisis in the balance of payments is widely identified as the proximate cause of the impetus towards substantial economic liberalization that was initiated in 1991. Also, the explicit orientation of the economic reforms programme has also been largely external, in terms of attempting to make the Indian economy more “competitive” in international trade terms, and trying to attract quantitatively significant flows of foreign capital to augment domestic savings.

**Sequencing of Reforms**

An ideal sequencing of reforms is given in Table 1.1.
TABLE 1.1
SEQUENCING OF ECONOMIC REFORMS

<table>
<thead>
<tr>
<th></th>
<th>Domestic</th>
<th>External</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real</td>
<td>• Setting up a market-price system</td>
<td>Removal of trade barriers (current account), that is trade account convertibility.</td>
</tr>
<tr>
<td></td>
<td>• Removal of subsidy</td>
<td></td>
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<tr>
<td></td>
<td>• Tax base widening</td>
<td></td>
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<td></td>
<td>• Privatization</td>
<td></td>
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<tr>
<td>Financial</td>
<td>• Raising domestic interest rates</td>
<td>Removal of capital controls, that is short term capital account convertibility</td>
</tr>
<tr>
<td></td>
<td>• Central bank autonomy</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Improving domestic capital markets</td>
<td></td>
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</tbody>
</table>


Model of Economic Management in India

Table 1.2 briefly summarizes the model of economic management in India before and after the reform process in India. The model vividly depicts a transformation process of Indian economy from State to market control.
## TABLE 1.2
MODEL OF ECONOMIC MANAGEMENT IN INDIA

<table>
<thead>
<tr>
<th>Pre-Reforms Strategies</th>
<th>Economic Reforms Strategies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Closed economy</td>
<td>Open economy</td>
</tr>
<tr>
<td>Self-reliance</td>
<td>Integrate with world markets</td>
</tr>
<tr>
<td>State-led economic growth</td>
<td>Market determined economic growth</td>
</tr>
<tr>
<td>Import substitution strategies</td>
<td>Export oriented strategies</td>
</tr>
<tr>
<td>License dominated regime</td>
<td>Delicensing, deregulations, debureaucralisation</td>
</tr>
<tr>
<td>Frequent state interventions</td>
<td>Selective and effective state interventions</td>
</tr>
<tr>
<td>Politically administered prices</td>
<td>Market determined prices at large</td>
</tr>
<tr>
<td>Not much concern for deficits</td>
<td>Contain all kinds of deficits</td>
</tr>
<tr>
<td>Development by inflationary process</td>
<td>Deflationary monetary and fiscal policies</td>
</tr>
<tr>
<td>PSUs as engines of growth</td>
<td>Private investment as growth engine</td>
</tr>
<tr>
<td>Dominance of PSUs</td>
<td>Withdrawal from between public and private sector</td>
</tr>
<tr>
<td>Philosophy of natural monopoly</td>
<td>Minimize gap between public and private sector</td>
</tr>
<tr>
<td>Restrictions on FDI and MNCs</td>
<td>Inducement to FDI and MNCs</td>
</tr>
<tr>
<td>Restrictions on currency movement</td>
<td>Liberalization of restrictions</td>
</tr>
<tr>
<td>State controlled interstates</td>
<td>Deregulation of interest rates</td>
</tr>
<tr>
<td>State controlled credit</td>
<td>Credit policy reforms</td>
</tr>
<tr>
<td>Underdeveloped capital market</td>
<td>Reforms in capital market</td>
</tr>
<tr>
<td>Huge public sector budgetary resources (PSBR) liability on government</td>
<td>Minimize PSBR</td>
</tr>
<tr>
<td>High tax rates</td>
<td>Tax reforms</td>
</tr>
</tbody>
</table>

Source: Compiled by the researcher from the various issues of RBI Monthly Bulletin
External Sector Management in India

The overall objective of external sector reforms was to achieve higher growth and efficiency without exposing the system to greater vulnerability. The position of the external sector today is in marked contrast to the balance of payments crisis of 1991, when default was perceived as a real threat. Several significant developments underscored the strength and vibrancy in India’s external sector.

The process of opening up the Indian economy has proceeded in steady steps.\(^5\)

- First, the exchange rate regime was allowed to be determined by market forces as against the Fixed exchange rate linked to a basket of currencies.
- Second, this was followed by the convertibility of the Indian rupee for current account transactions with India accepting the obligations under Article VIII of the IMF in August 1994.

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• Third, capital account convertibility has proceeded at a steady pace. At present, the de facto full capital account convertibility for non-residents is supported by the calibrated liberalization of transactions undertaken for capital account purpose in the case of residents.

• Fourth, the distinct improvement in the external sector has enabled a progressive liberalization of the exchange and payments regime in India. Reflecting the changed approach to foreign exchange restrictions, the restrictive Foreign Exchange Regulation Act (FERA), 1973 has been replaced by the Foreign Exchange Management Act (FEMA), 1999.

• It may not be entirely an issue of semantics that the “Exchange Control Department” of the RBI has been rechristened as “Foreign Exchange Department”. Thus, the robust external sector facilitated further liberalization to the exchange and payments.

Importance of the Study

Over a period of time, there has been a marked change in the ideology of the government towards integration of Indian economy with the World economy. The change in the ideology is reflected in the attitude of the government towards LPG policies.
India is no exception to the changes taking place in the entire World. With the gradual change in the ideology regarding the approach to development (from the inward oriented import substituting approach to the outward looking approach), during the late 1980s and especially after the Balance of Payments Crisis of 1991-92, the liberal approach towards trade and capital has been adopted by the Indian government. In this global integration process, the promotion of external trade, reduction of external debt and enhancement of foreign direct investment have assumed very crucial importance in the Indian economy. Liberalization has involved a significant paradigm change from the protective tendencies adopted in the past. The ideological predilections of Nehru and the Mahalanobis model of socialistic planning have given way to the new waves of globalization, privatization and liberalization.

In view of the globalization process taking place with an astonishing speed in the various parts of the World, the question of openness in trade and capital for economic development in the emerging economies has come into a sharper focus.

India is one of the developing countries, which has introduced a liberalization policy and as a part of it, has relaxed the FDI regulatory
framework on a selective basis with reference primarily to the industrial sector since 1991. Such a positive and ‘open-door’ policy adopted by India towards foreign trade and investment is in contrast to its earlier ambivalent and restrictive approach. Likewise ‘Trade or Perish’ is the new mantra for the policy makers. This paradigm shift is a serious issue to the scholars, economists and intellectuals of our country. Some economists make a big hue and cry over this liberalized attitude towards foreign trade and capital. They consider this as a move towards mortgaging our country to the multinationals of the developed countries and which will pave the way for the, emergence of ‘neo-colonialism’.

The mainstream economists on the other hand believe that the impact of such policy is positive, since it brings to the developing countries a package of capital, foreign exchange, technology, managerial expertise, skills and other inputs, which are critical for the development of the emerging economies.

The change in policy, as such, is a controversial one, but in the present day political climate, it is likely to continue in the coming years also. It is an issue, which needs more clarity and understanding. Moreover India is going to complete two decades of external sector reform very
shortly. Therefore, it is apt to take a serious research on external sector reform in India.

**Statement of the Research Problem**

As per the reviews made by the researcher on economic reforms and its impact on external sector in India, the liberalization process in India seems to be irreversible. While public opinion in India continues to move towards the view that liberalization of the economy has been good and more of it is needed, some scholars, have turned skeptical. Economists Bradford Delong and Dani Rodrik,\(^6\) for example, argue that reforms cannot be credited with India’s higher rates in recent years because the shift in the growth rate preceded the reforms of the 1990s.

In a related but slightly different vein, Joseph Stiglitz has contended that India also, like China, has bought the least into the globalization story that the IMF and others are selling. Recently Kamal Nayam Kabra in his article in alternative Economic Survey, India 2004-05 titled “Disequalising Growth”. The Achilles Heel of Liberalisation highlighted the failure of

\(^6\)IMF Survey (2003) “India: are the skeptics is right?”, *International Monetary Fund*, Vol. 32, No.21, December 1, p.16
reforms facts of Harsh Reality and listed a long list of evils of globalization process in India.

But De Rato the former, IMF Managing Director compared India’s current economic boom to the early stages of the ‘take off’ previously expressed by other Asian Economies. Moreover, he argued that if India can boost annual growth from 6 to 8 per cent annually, it can double average incomes in 11 rather than 16 years, dramatically rising living standards. Who’s right? To test the move, i.e, the way, the external sector of the Indian economy is moving the researcher has chosen this vibrant topic for the study.

**Objectives**

The specific objectives of the study are:

1. To analyse the dynamics and connection between Foreign Direct Investment and Economic growth under liberalization in India.
2. To examine the growth, determinants and management of Foreign Exchange Reserves in India.
3. To investigate the growth, composition and the factors that influence the external debt in India.
4. To study the current and capital account changes in the balance of payments in India.

5. To offer appropriate suggestions for the improvement of the external sector in India based on the findings of the study.

Limitations of the Study

Although the study analyses some critical issues connected with external sector variables, like trade, debt and investment inflows into India, more particularly since 1991, inadequate availability of data in certain macro economic variables acted as a barrier in the treatment of all aspects of external sector.

Moreover the study is macro in its nature portraying the whole of India as unit of study; hence, comparison at micro level is not feasible.

Admittedly, the study has limitations arising from the lack of uniformity in the treatment of the concepts and its weak database; yet, the findings do give clues on the major issues for policy reforms. The study serves to mould the market signals for attracting trade and investment inflows and reducing debt levels in a manner that is consistent with
economic development with a national flavor in the contemporary world of increasing international integration.

As the study is completely based on secondary data, the limitations pertaining to secondary data such as inadequacy and lack of reliability apply to this study also.

**Chapterisation**

The present study “An Analysis of Economic Reforms and its Impact on External Sector in India” has been presented in seven chapters.

The first chapter is the introductory chapter which introduces the concept external sector, background of economic crisis, economic reforms and external vulnerability, sequencing of reforms, model of economic management in India, external sector management in India, importance of the study, statement of the research problem, objectives of the study, limitations of the study and also presents the Chapterisation of the study.

The second chapter is devoted to relevant Review of Literature and Methodology and database.
The third chapter presents the dynamics of foreign investment, structural change in FDI and causal connection between Foreign Direct Investment and Economic Growth under Liberalisation in India.

The fourth chapter examines the growth and determinants of Foreign Exchange Reserves in India and the structural change in Forex reserves as a result of introduction of external sector reforms.

The fifth chapter investigates the growth, composition and the factors that influence the growth of external debt in India.

The sixth chapter deals with the current and capital account changes in the balance of payments position of India in the post-liberalization era.

The seventh chapter presents the summary of findings and offer appropriate suggestions for the improvement of the external sector in India based on the findings of the study and an overall concluding remark.