Chapter 3

*Key Economic Reforms*  
*Introduced in India*
Chapter - 3

Key Economic Reforms Introduced in India Since 1991

3.1 Introduction

From 1991 onwards India has witnessed wide ranging reforms in various sectors of the economy. This chapter is devoted to a brief overview of the reform measures that have been introduced in the important sectors of the Indian economy.

As background to this main theme, the concept of economic reforms and the broad strategy adopted for their implementation in developing countries in general are briefly explained in Section 3.2. Section 3.3 presents a bird’s eye view of the reform measures that have been introduced in different sectors of the Indian economy since 1991. The final section summarizes the main conclusions of the present chapter.

3.2. Economic Reforms: Concept and Strategy

The term ‘economic reforms’ is probably one of the most widely used and popular in the field of economics today. It means an inclination towards neoliberal policies. Faced with the structural weaknesses on the domestic front and severe external shock a large number of developing countries have implemented economic reform during the past several decades especially since the decade of the 1980’s with a view to ensure a better allocation of resources and thereby improve economic performance through changes in economic policies (Sharan and Mukherjee, 2001). The process of economic reform has included macroeconomic stabilization and structural adjustment.

The main objective of stabilizing the macroeconomic system has been to restore the external balance on the balance of payments and to reduce inflation at a low and manageable level in the short run. Stabilization has been sought to be realized by means of measures that influence the demand side of the economy.
The tools have included:

- Devaluation of overvalued exchange rates.
- Reduction of budget deficits, raising taxes, cutting expenditure, reforming tax system, etc.
- Restructuring of foreign debts.
- Financing government debts on capital markets instead of through monetary financing.
- Increasing interest rates (financial liberalization); increasing food prices; increasing prices of public services.
- Controlling wages

Structural adjustment measures have been directed towards long run improvements in the supply side of an economy. The scope of structural adjustment programme has been wider and aimed at reducing the role of the state and liberalise the whole economy, so that prices actually reflect scarcity and promote more efficient economic behavior. Discrimination against agriculture in favour of the industrial sector should be ended. Restrictions on trade and capital flows should be phased out. Protection of domestic industry by means of tariffs and quotas should be reduced. Domestic firms should be exposed more to foreign competition and should try to penetrate exports markets. Exports should follow the lines of comparative advantage.

The adjustment packages have frequently included the following policy moves (Szirmai, 2005).

*Liberalisation of domestic markets*

- Abolition of price controls and liberalization of price policies; an end to the practice of indexing wages to inflation, abolition of minimum wage regulations.
Trade policy

- Depreciation of overvalued exchange rates. A cheaper currency makes imports more expensive and exports cheaper. Import-substituting domestic production becomes more profitable.

- Liberalisation of trade policy by abolishing imports quotas; import tariff systems are made more transparent and tariffs themselves are reduced. When exchange rates are determined by market forces, growth of imports will lead to depreciation of the exchange rate. This in turn makes for recovery of the external balance. Liberalisation of imports also undermines monopoly positions of traders who profited from import licensing under a protectionist regime. Former domestic monopolists are exposed to the discipline of international competition.

- Striking a balance between incentives for import substituting production and incentives for export production, so as to promote a stronger outward orientation.

The Public sector, Fiscal policy, Government expenditures, Public enterprises

- Reforms of the budgetary and fiscal system, aimed at better control of government expenditure and more effective collection of taxes.

- Reducing government expenditures and government deficits.

- Restructuring the priorities in government investment. More priority to investment in the agricultural sector.

- Increasing the government's capacity to formulate and execute government investment programmes; increasing the general efficiency of government.

- Increasing the output and efficiency of loss-making public enterprises (parastatals).

- Privatisation of public enterprises and public activities.
• Reducing subsidies for energy and food. Increasing taxes on consumer goods.

*Capital market*

• Liberalization of domestic and foreign capital markets.

• Deregulation of interest rates. Higher interest rates elicit higher domestic savings. Higher interest costs lead to a more efficient use of capital in the production process.

• Creating new financial institutions; privatization or restructuring of government controlled banks.

*Agricultural policy*

• Increasing agricultural prices in order to stimulate agricultural production.

• Abolishing or limiting the role of state marketing boards that used to have a monopoly on the trade in food and export products. Liberalisation of agricultural trade.

• Reducing subsidies for agricultural inputs.

*Industrial policy*

• Intensifying incentives for efficient production in the industrial sector, among others by refusing to bail out unprofitable firms and investment projects.

*Energy policy*

• Increasing the domestic prices of energy to relieve the government budget; promoting the domestic supply and efficient use of energy.

Thus, economic reforms have meant macro economic variables adjustment in the economy by bringing about reforms of structural adjustment measures at micro level (a long term measure) and stabilization measures at macro level (taken to tackle
immediate problems, or a short term measures). These adjustments have led to radical changes in the existing policies. The need of adjustment was felt due to failure of economic mechanism in a country which slowly engulfed the entire sectors or the sectors critical to economic growth and development in an economy. The reasons for adjustment in the economy or economic reforms included external and internal instabilities.

Though the stabilization programme and structural adjustment programme differ they complement each other. The imbalances in the economy that result in financial crisis in the short term are partly due to inadequacy of domestic supply with respect to domestic demand. This causes inflation and deficits on the current account of the balance of payments. In the long term removal of structural impediments and increased flexibility of the production structure are the best ways to prevent financial crisis from recurring.

3.3 Economic Reform in India

As is well known India faced a crisis of unprecedented severity in the early 1990s. The budget deficit had increased from 0.9% of GDP in 1980-81 to 2.1% of GDP in 1990-91. The revenue deficit during the same period had gone up from 0.2 percent of GDP and 3.5 percent. The gross fiscal deficit had reached the level of 8.4 percent of GDP in 1990-91 from 7.5 percent in 1984-85.

The continuously growing budgetary deficit was largely financed by deficit financing which in turn led to inflationary pressure in the economy. By August 1991, the inflation rate had climbed to a peak of 17 percent. Rising prices especially that of food hit hard the fixed income group and made Indian products non-competitive in the international market.
The fiscal deficit was met by recourse to borrowings and the internal debt of the government had reached the level of 53 percent of GDP at the end of 1990-91 as against 35 percent of GDP at the end of 1980-81. The burden of servicing the debt was onerous.

Interest payments which were 2 per cent of GDP and 10 percent of total central government expenditure in 1980-81 had gone up to 4 percent of GDP and 20 percent of total central government expenditure in 1990-91. Interest payments absorbed 36.4 percent of total revenue collections of the central government in 1990-91. This was an unsustainable situation and the danger of the government falling into debt trap was real.

The balance of payments situation was equally fragile. The current account deficit had reached the level of $ 9.7 billion or 3.67 percent of GDP in 1990-91 as against $ 2.1 billion or 1.35 percent of GDP in 1980-81.

These continuously growing deficits had to be financed by borrowing from abroad. India’s external debt rose from 12 per cent of GDP at the end of 1980-81 to 23 percent of GDP at the end of 1990-91. The growing external debt led to an increase in debt service burden from 10 percent of current account receipts and 15 percent of export earnings in 1980-81 to 22 percent of current account receipts and 30 percent of export earnings in 1990-91. The balance of payments position was on the brink of disaster as in late June 1991, the level of foreign exchange reserves had dropped to levels which were not sufficient to finance imports of even ten days. Defaults in terms of financing imports and meeting debt service payments looked imminent.

The crisis was the outcome of the long term constraints of the preceding decades especially the 1980s and certain immediate factors (Tripathy, 2009). After attaining independence from British rule in 1947, India adopted an inward looking
development strategy which was largely influenced by:-

(i) The cynicism of policy-makers regarding any possible help from the rest of the world by way of investments, transfer of technology and trade.

(ii) Reservation regarding the ability of the market forces to bring about, of their own, an optimum allocation of resources, thus, balancing the country's two main objectives – 'growth' and 'equity'.

The strategy sought to assert government planning over most sectors of the economy and to promote relative economic self-sufficiency. It was designed around such important basics as: extensive government spending on infrastructure, the promotion of the public sector, pervasive regulatory authority over private sector investment, and extensive use of trade and investment barriers to protect local firms from foreign competition.

The strategy did pay off and India was able to achieve some economic goals such as rapid industrialization. But the overall effect of this strategy was the promotion of widespread inefficiency throughout the economy.

In the 1980s some piecemeal economic reforms were introduced to modernize domestic industry and increase India's export earnings when the government strategy shifted in favour of liberalization and openness (OECD, 2010). This shift resulted in acceleration of economic growth in the 1980s. However, the economic growth during this period was mainly financed by expansionary fiscal policy which eventually spilled over to the external sector fuelling the external payment crisis in 1991.

The two most important immediate factors which triggered the economic crisis in 1991 were the Gulf war of 1990 and the collapse of the Soviet Union. The Gulf war
led to the surge in India's oil import bill and cessation of exports to Iraq due to UN trade embargo on that country.

The collapse of Soviet Union, India's major trading partner at that time further aggravated the economic crisis and undermined India's faith in central planning.

To deal with this crisis, India initiated an emergency programme of economic stabilization aimed at correcting the weaknesses that had developed on the fiscal and balance of payments fronts over the past decades. Simultaneously, it also embarked on a programme of structural reform to remove the rigidities that had entered into the various segments of the economy. In this process, India introduced several fundamental changes in fiscal policy, the monetary and financial system, industrial policy, the external trade and payment system (Table 3.1). We discuss below them in a sequential way.

**Fiscal Reforms:**

Fiscal policy deals with government revenues and expenditure. It can be a critical component of the policy framework for achieving sustained growth with macroeconomic stability. But unproductive expenditure, tax distortions and high deficits may constrain the economy from realizing its full growth potential. If fiscal deficit remains high it can be financed by printing money or by borrowing from domestic and foreign sources. Increase in money supply leads to higher levels of inflation while borrowing might lead a country to the debt trap. Similarly high fiscal deficit may lead to higher import demand through expansion in aggregate money supply and aggregate demand. On the other hand inflation and the resultant increase in cost of production may reduce the competitiveness of exports resulting in a trade deficit. Further, external borrowings especially commercial borrowings may produce
The process of macroeconomic adjustment or economic reform is explained in Table 3.1.

### Table 3.1

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Source: Prepared by Researcher.
deleterious effects upon the balance of payments of the country due to higher burden of
debt servicing and outflow of foreign exchange. Thus, at a macro-economic level, fiscal
deficits inevitably spill into balance of payments problems and create inflationary
pressures in the economy.

The fiscal situation in India was under strain throughout the 1980's. But it
reached a critical situation in 1990-91. The gross fiscal deficit of the central
government was more than 8 percent of GDP since 1985-86, as compared with 6
percent at the beginning of 1980's and 4 percent in the mid-1970's (Economic Survey,
1992-93). Such fiscal deficits were mainly the outcome of unabated growth of non-plan
expenditure and poor returns from investments made in the public sector. The deficits
were unsustainable and identified as the underlying cause of the twin problems of
inflation and the difficult balance of payment position.

Therefore, the Union Budget for 1991-92 took bold steps in trade and
industrial policy aimed at improving efficiency of the economy and improving its
international competitiveness. This restructuring was essential to ensure longer-term
viability in the balance of payments and to restore the conditions for rapid growth.
These measures have had some success. There was a marked improvement in foreign
exchange reserves, with reserves reaching Rs.11410 crore ($4.4 billion) in the third
week of February 1992. The rate of inflation also declined from the peak level of 16.7
percent reached in August 1991 to 11.8 percent in February 1992. However neither the
balance of payments nor the problem of inflation could be overcome. A lasting solution
to these problems called for sustained corrective action which continued to receive top-
priority in 1992-93. The objective of policy in coming years became consolidation of
the gains made thus far and to bring these problems firmly under control, while
simultaneously raising the rate of growth, and restoring the Government's capacity to
pursue the basic goals of generating employment, removing poverty and promoting equity (Economic Survey, 1991-92)

In order to make Indian tax system more elastic and broad based government of India appointed Raja Chelliah Committee on Tax Reforms in 1991 (Tax Reforms Committee, 1991). The Committee offered various suggestions. Following are the suggestions:

1) MODVAT was extended to many industries.
2) Income tax filing procedures were simplified.
3) Services such as— insurance, telephones, etc was subjected to taxes.
4) Corporate tax rates were lowered
5) Custom duties and excise duties were reduced, etc.

Thus, the tax base was widened and direct and indirect taxes were reduced. The personal and corporate income taxes were reduced to 30% and 35%. The dividends were made taxation free for shareholders etc.

The Union Budgets for 1996-97 and 1997-98 saw some innovative measures combined with further reduction in rates of income tax. Notable among these were the introduction of a Minimum Alternate Tax (MAT) on companies, an estimated income scheme for small businesses and levy of excise duty on certain items presumptively on the basis of their production capacity. To widen the coverage of income tax, filing of tax returns was made obligatory based on certain economic criteria such as ownership of motor vehicles, house property, foreign travel, and subscription of a telephone line. These base widening efforts were, however, somewhat undermined by generous tax concessions for investment in certain areas like infrastructure. Some relaxations were granted in the scheme of MAT too and a voluntary disclosure of income scheme
(VDIS) was launched in 1997 to map up tax on unaccounted incomes in a big way. Tax reforms on the states side were focused mainly on the sales tax, which by all account were marked by acute complexities. The aim was to install a system of destination principle VAT replacing the multiplicity of levies and shifting the burden of taxation from production to consumption (Bagchi, 1998).

India also attempted to deal with its fiscal imbalances by reforming budget institutions. After a three-year discussion, the FRBM law was enacted in 2003. Its key objective was to restore fiscal sustainability by setting a medium term target to guide fiscal policy. The target was embedded within the framework that placed increased emphasis on transparency.

The important fiscal measures introduced in India in post reform period have included:

i. An increase in prices of petroleum products.

ii. Net tax increases equal to 0.5 percent of GDP.

iii. Steps to improve tax compliance, including wider deduction of tax at source.

iv. A decision to sell up to 20 percent of equity in some public enterprises, with a yield of 0.4 percent of GDP.

v. Sharp cuts in subsidies: abolition of export subsidies and sugar subsidy, and a rise of 30 percent in fertilizer prices.

vi. A reduction in defence expenditure from 3.1 percent to 2.8 percent of GDP.

vii. Cuts of 0.3 percent of GDP in transfers to public enterprises and restraint on other expenditure (Desai, 1999)

These measures have focused around an increase in revenues and a reduction in expenditure.
Monetary and Financial Sector Reform:

The period since 1991-92 has witnessed some far reaching changes in the monetary policy framework and the monetary policy has emerged as the chief instrument of macroeconomic stabilization as well as a vehicle for the subsequent structural reforms in the financial system.

India like most developing economies followed the path of planned development after independence based on the assumption that public savings would fund higher levels of investment. But this did not turn out to be true. The public sector instead of being a source of savings for the community’s good became a censor of community’s savings (RBI, 2001-02:V-1). As a result, the government had to take increasing recourse to a draft of resources from the Reserve Bank and the banking system by fiat.

The fiscal dominance affected the conduct of monetary policy and resource allocation in many ways. First by raising steadily the statutory liquidity ratio (SLR) to provide a capital market for government borrowings. This ratio was hiked to a peak of 38.5 percent of net demand and time liabilities (NDTL) in September 1990 from 25.0 percent in September 1964 (RBI, Ibid, p V-1).

Second as the higher SLR failed to fund the fiscal deficit, the gap was filled by an almost monotonic increase in the monetization of fiscal deficit.

Third, the excessive monetary expansion resulting from the monetisation of the fiscal deficit resulted in higher inflation which in turn further widened the deficit.

Fourth to contain the inflationary impact of the monetization of the fiscal deficit, the RBI had to hike the Cash Reserve Ratio (CRR) which imposed an indirect tax on banking system. The commercial banks were forced to set aside more than 50
percent of their incremental resources for meeting statutory pre-emption by March 1991.

Finally to contain the interest burden of Public debt, the RBI administered interest rates, both on the lending and the deposit side. This resulted in financial repression and limited the interest rate channel of monetary policy transmission.

The monetary and credit policy in the pre-reform period were also directed towards regulating credit with a view to curb inflationary pressure, promote its effective use, prevent the large borrowers from pre-empting the use of scarce credit and enlarge the spectrum of borrowers covered by banks in the overall context of national policies (RBI, 2001-02,V-2). All these led to a decline in the productivity and efficiency of the banking system.

Reform in the monetary policy was considered essential to ensure macroeconomic stability and set free the process of price discovery with a view to enhancing the allocative efficiency of the financial markets. The constituents of monetary policy reform in India since 1991 have included: introduction of an auction system for the central government’s market borrowings; replacement of treasury bills by ways and means advances (WMA); reactivisation of the bank rate; deregulation of interest rates and deregulation of credit (Sury, 2011).

Reforms in the monetary policy have also been accompanied by a comprehensive financial sector reform. The main thrust of reforms in this sector has been on the creation of efficient and stable financial institutions and markets.

Reforms in the commercial banking sector have been largely based on the reports of the committees set up under the Chairmanship of former RBI Governor, M. Narsimham. The first reports on financial system (1992) focused mainly on enabling and strengthening measures. It recommended:
1) Progressive reduction in cash reserve ratio to 3%-5%, and statutory liquidity ratio to 25% over the period of five years.

2) Deregulation of Interest rates.

3) Electronic banking.

4) Regulation of the Banking sector by RBI.

5) Widening of base of SEBI as a market regulator.

6) Risk management

7) Permission to raise capital from public by profitable bank.

8) Capital Market Liberalization.

9) Abolition of Branch licensing.

10) Special tribunals to be set up for recovery of loans.

11) Encouragement to private sector banks, including foreign banks, by liberalizing policies.

The second report on Banking sector reforms placed greater emphasis on structural measures and recommended:

1) Further strengthening of banking sector in India with greater autonomy for PSB’s (public sector banks) to make them equivalent to international standards. This will speed up inflows of capital.

2) Updating of banking laws.

3) Merger of strong banks, which will encourage international trade. But the merger of strong bank with weak bank must be avoided.

4) International status should be provided to two / three strong / large Indian banks.

5) Small banks should be set up to enhance say, local trade.

6) Raising capital adequacy ratio (CAR) for increasing risk absorption capacity.
CAR should be raised to 9% in 2000 and 10% in 2002 along with panel provisions.

7) Non-Performing Assets (NPAs) should be reduced to 3% in by the end 2002.

Following these recommendations significant reforms in the Banking sector in India have been introduced since 1991. The major policy reforms include dismantling of administered interest rate, major reduction in SLR and CRR, abolition of firm specific credit controls, permission to private players including foreign participant in the banking sector and improving the banking supervision, etc.

**Industrial Policy Reform:**

The process of economic reforms introduced in India in 1991 got a big boost when the Government of India announced a new industrial policy in the Indian Parliament on July 24, 1991. The new policy introduced radical changes to unshackle the Indian industrial economy from the cobwebs of unnecessary bureaucratic controls and make market internationally competitive in terms of price and quality. In pursuit of these objectives the government announced a series of initiatives in respect of the policies relating to the following areas:

**Delicensing:** Prior to reforms, under the Industrial Act of 1951, all the key industries in India had to acquire license for establishing new units, relocate industries, capacity expansion, to introduce any new commodity in market etc. This process heavily restricted industrial development. In post reform scenario, a radical change was made.

Industrial licensing was abolished for all except 18 industries where it was retained, “for reason’s, related to security and strategic concerns, social reasons, problems related to safety and overriding environmental issues, manufacture of hazardous nature and articles of elitist consumption” (Government of India, 1991).
Exemption from licensing was granted not only to the new investment projects but also to the existing units for expansion and manufacturing of new items. True to the commitment in the policy that “Government’s policy will be continuity with change”, subsequent delicensing has left only five sectors subject to compulsory licensing. These were:

- a) Arms and ammunition, explosives and allied items of defense equipment, defense aircraft and warships.
- b) Atomic substances.
- c) Narcotics and psychotropic substances and hazardous chemicals.
- d) Distillation and brewing of alcoholic drinks.
- e) Cigarettes/cigars and manufactured tobacco and substitutes (Panagariya, 2004).

**Dereservation:** Under the Industrial Policy Resolution 1956, the number of industries reserved for the public sector was 17. The 1991 industrial policy reduced this number to 8. As a result of further reviews, only atomic energy and railway transport remained reserved for the state.

**Disinvestment:** Another important step taken to reform Indian industrial sector has been the ‘disinvestment’ programme. It implies privatization or transfer of public assets to private sector. In 1993 committee under the chairmanship of Dr. C. Rangarajan was set up to look into the disinvestment of public sector units (PSU’s). The committee recommended that except for atomic energy and defense where government should have majority holdings in equity, PSU’s can be disinvested upto any limit. Full fledge disinvestment commission was constituted in 1996. Following is list of few PSU’s where partial or full disinvestment has been implemented :

1) Oil and Natural Gas Corporation.
2) Gas Authority of India Limited (GAIL).
3) Mahanagar Telephone Nigam Limited (MTNL).
4) Power Grid Corporations.
5) Indian Airlines.
6) Indian Petrochemicals Corporation Limited (IPCL).
7) Hindustan Zinc Limited.
8) Modern Food Industries (India) Limited.
9) National Fertilizers Limited (NFL).
10) LNG Petro Net.
11) Videsh Sanchar Nigam Ltd. (VSNL), etc.

Amendment in MRTP Act: Under this Act firms with assets above a certain size (Rs.100 crore since 1985) were classified as MRTP firms. Such firms were permitted to enter selected industries only on a case by case approval basis. This had a deleterious effect on many large firms in their plans for growth and diversification. The law regulating monopolies has been amended to remove the threshold limit of Rs. 1 billion on the assets of large business houses and to eliminate the need for prior approval from the government for capacity expansion, capacity creation, amalgamation, mergers or takeovers on the part of sick companies (Nayyer, 1996). The amended Act gives more emphasis on prevention and control of monopolistic, restrictive and unfair trade practices so that consumers are adequately protected from such practices.

Liberalisation of FDI (Foreign Direct Investment) Regime:

Industrial liberalization was accompanied by a radical restructuring of the policy towards foreign investment. Automatic approval of upto 51 percent of foreign ownership was first introduced in 34 priority sectors including mostly manufacturing
industries and a few services sector. The limit was subsequently raised to 74 percent and then to 100 percent for many of these industries. To encourage exports majority foreign equity ownership up to 51 percent was also allowed for trading companies primarily engaged in export activities. Automatic approval was provided for technical collaboration agreements in high priority sectors with certain conditions on royalty payment and in many other sectors if such agreements do not require the expenditure of foreign exchange.

External Sector Reforms:

Reforms in the external sector have been more extensive and touched upon every aspect of the balance of payment problem.

To begin with, the exchange rate policy regime was changed from a fixed exchange rate system to market determined one.

After gaining independence India followed the par value system of the IMF and the rupee was pegged to the pound sterling on account of the historic links with Britain. This system remained in vogue until 1975 when rupee was delinked from the pound and pegged to an undisclosed currency basket until 1992. During this period, there was no active use of changes in nominal exchange rate as a tool of macroeconomic management except for devaluation of rupee in 1949 and 1966. The rupee remained overvalued during most of this period adversely affecting exports and generating excess demand for imports restricted by QRs (Quantitative Restrictions).

Following the BoP crisis in 1991, the rupee was adjusted downward in two stages on July 1 and July 3, 1991 by around 18-19 percent against a basket of five currencies namely the U.S dollar, the Deutschmark, the British pound, the French franc and the Japanese yen. The downward adjustment of the rupee was followed by the
introduction of the Liberalization Exchange Rate Management System (LERMS) in March 1992 under which a dual (official and market determined) exchange rate system was adopted. Forty percent of foreign exchange receipts from exports of goods and services were to be surrendered at the official exchange rate while the remaining 60 percent could be converted at the market exchange rates. But as this system was criticized for an implicit tax on exports resulting from the differentials in the rates of surrenders of exports proceeds, it was replaced by a unified market determined exchange rate system in March 1993. Since then the rupee has been kept on float and its value is determined by the forces of demand and supply in the foreign exchange market. The Reserve Bank of India (RBI), however, reserves the right to intervene in the market to enable orderly conduct (Rangarajan 1997). The rupee was made fully convertible on trade account in the union budget 1993-94. On August 1994, the rupee was made fully convertible on all current account transactions. This means importers and exporters can acquire foreign currency at the market determined rate as opposed to the unfavourable government determined rate that was prevalent in the pre-reform era.

While convertibility on trade account has been accomplished, the movement on the capital account convertibility has been rather slow and cautious. Currency of a country is deemed to be convertible on capital account when the local financial assets can be converted into foreign financial assets and vice versa at market determined exchange rates without government controls, regulations, etc.

After making rupee convertible on current account transactions in August 1994, the Reserve Bank of India appointed in 1997, a Committee under the Chairmanship Shri S.S. Tarapore, the former Deputy Governor of RBI to build a platform for Capital Account Convertibility in India.
The committee viewed that upshots in different economies differ and cannot be generalized or applied unanimously. The end product differs from economies to economies depending upon their macroeconomic performance prior to introduction of capital account liberalization and how far they have been successful in establishing their pre-conditions and timing and sequencing of measures of liberalization of capital account.

For India the recommended among others that capital account convertibility is possible only after the pre-conditions/signposts laid down by it are met with and it should be sequenced over a period of three years beginning with 1997-98.

Among the pre-conditions/signposts, it laid emphasis on:

1. Fiscal consolidation.
2. A mandated inflation target, and

**Fiscal Consolidation:** The committee proposed a potent macroeconomic set up and sustainable fiscal deficit as a vital and key pre-condition for capital account convertibility in India.

It recommended that gross fiscal deficit as percentage of gross domestic product be reduced from budgeted 4.5 percent in 1997-98 to 4.0 percent in 1998-99 and further to 3.5 percent in 1999-2000.

**Mandated Inflation Rate:** The Committee viewed that inflation should be in single digit in order to instigate capital account convertibility and empowering RBI will be of utmost interest on inflation mandate. To quote:

"There should be a medium-term inflation mandate approved by Parliament and only Parliament should alter that mandate. Once the mandate is given, the RBI should be given freedom to use the
instruments at its command to attain the medium-term inflation target. Intensification or withdrawal of public intervention in price formation or a shock in the real sectors could warrant a review of the mandate but there should be clear and transparent guidelines on the circumstances under which the mandate could be changed”.

Tarapore Committee Report (1997)

The committee advised that there should be 3%-5% mandated rate of inflation for the three year period from 1997-98 to 1999-2000.

**Strengthening of the Financial Sector:** For strengthening the financial system the committee suggested that:

1. Interest rates to be fully deregulated in 1997-98 and any formal or informal interest rate controls to be abolished.
2. CRR to be reduced in phases to 8 percent in 1997-98, 6 percent in 1998-99 and to 3 percent in 1999-2000.
3. Gross non-performing assets (NPA) as percentage to total advances to be brought down in phases to 12 percent in 1997-98, 9 percent in 1998-99 and to 5 percent in 1999-2000.
4. 100 percent marked to market valuation of investment for banks.
5. Best practices for forex risk management by banks.
6. Banks to follow international accounting disclosure norms.

As an important macroeconomic indicator the committee suggested that:

1. A monitoring band of +/-5 percent around the neutral Real Effective Exchange Rate (REER) to be introduced and intervened by the Reserve Bank when REER is outside the band.
2. Debt service ratio to be reduced to 20 percent from 25 percent.
3. The foreign exchange reserves should not be less than 6 months imports. (RBI, 2001-02, VII-22)

The Tarapore Committee report was a landmark in Indian economic history. It provided a comprehensive package to lead India on the road to capital account convertibility and integrate and globalize the Indian foreign exchange market with the world economy. But the major difficulty with the report was that it gave a period of three years only for capital account convertibility to be achieved. The period was too short and the pre-conditions and macro-economic indicators could not be achieved in such a short period. Therefore the report remained largely fallow in terms of implementation. The emergence of East Asian Crisis at that time further dumped all expectations and again caged the policies of liberalization in India. Nevertheless the spirit towards liberalization of capital account survived and over the years India took several measures in this direction. The measures are summarized as under (Misra and Puri, 2009):

1. All deposits schemes for NRIs have been made fully convertible.

2. NRIs will be free to repatriate in foreign currency their current earnings in India such as rent, dividend, pension, interest and the like based on appropriate certification.

3. Indian citizens have been permitted to maintain foreign currency accounts out of foreign exchange earned/retained from travel expenses.

4. Both, listed Indian companies and resident individuals have been permitted to invest abroad in companies listed in recognized overseas stock exchanges, and having at least 10 per cent shareholding in a company listed on a recognized stock exchange in India, on January 1 of the year of investment.
5. Indian companies are allowed to access ADRs/GDRs (American Depository Receipts/Global Depository Receipts) markets through an automatic route without approval of the Ministry of Finance subject to specified norms and post-issue reporting requirements.

6. FDI is allowed up to 100 per cent on the automatic route in most sectors subject to sectoral rules/regulations applicable.

7. The new policy announced in January 2004 significantly raised the ceiling under the automatic route from US $ 50 million. ECBs (external commercial borrowings) have now been allowed under an automatic route up to US $ 500 million (for ECBs with average maturity of more than 5 years) and up to US $ 20 million (for ECBs between 3 to 5 years of average maturity).

8. Indian parties are allowed to make direct investment in a joint venture/wholly owned subsidiary outside India without prior approval of the Reserve Bank/Government subject to certain conditions.

9. Investment in overseas financial sector is also permitted subject to certain terms and conditions.

10. A person resident in India being an individual is permitted to acquire foreign securities by way of gift, inheritance or under cashless Employees Stock Option Scheme (ESOP). In addition, employees or directors of the Indian office/branch/subsidiary of a foreign company or an Indian company are permitted to acquire ESOPs against remittance without any monetary limit.

11. Indian corporates who have set up overseas offices have been allowed to acquire immovable property outside India for their business as well as staff residential purpose.
12. Two categories of EEFC (Exchange Earners’ Foreign Currency) account holders have been specified, one those who can retain upto 100 per cent of their receipt in foreign exchange and others who can retain 50 per cent. A 100 per cent Export Oriented Unit (EOU) or a unit situated in (a) Export Processing Zone (EPZ) or (b) Software Technology Park (STP) or (c) Electronic Hardware Technology Park (EHTP), status holder exporters, professionals are eligible to credit upto 100 per cent of their foreign exchange receipts to their EEFC account.

13. An NRI is permitted to purchase/sell shares and/or convertible debentures of an Indian company through a registered broker on a recognized stock exchange under certain conditions.

14. ADs (Authorized Dealers) in India are permitted to borrow in foreign currency subject to certain conditions.

15. ADs have been given freedom to undertake investments in overseas markets subject to the limits approved by the bank’s Board of Directors.

16. Commercial banks have been permitted to provide, at their discretion, buyers credit/acceptance finance to overseas parties for facilitating exports of goods and services from India subject to certain conditions.

17. Mutual Funds have been permitted on application, after obtaining necessary permission from SEBI, to invest in ADRs/GDRs of Indian companies and rated debt instrument in overseas market. Recently, they have also been permitted to invest in equity of overseas company, subject to conditions applicable to corporates/individuals. RBI has recently raised the limit on overseas investment by mutual funds from $5 billion to $7 billion.
18. General permission has been granted to registered foreign institutional investors to purchase shares/convertible debentures of an Indian company through offer/private placement subject to specified ceiling.

19. Banks fulfilling certain criteria have been permitted to import gold. Banks have also been permitted to accept gold under the Gold Deposit Scheme.

20. On February 4, 2004, the Reserve Bank allowed the resident Indians to remit up to $25,000 a calendar year for any current or capital account transaction, or a combination of both (this limit has been raised in a phased manner to $2,00,000). This provision enables resident Indians not only to open and operate foreign currency accounts outside India, but also to use the money remitted to those accounts to acquire financial or immovable assets without prior approval from Reserve Bank.

21. In a further step towards capital account convertibility, the government relaxed remittance norms further on February 6, 2004. As a result of these relaxations (i) no permission is now needed to buy health insurance from abroad; (ii) short-term credit for overseas offices will not need Reserve Bank permission; (iii) advertisements on foreign television channels have been allowed without any ceiling; (iv) no Reserve Bank approval is required for payment of royalty and fees for technical collaborations; (v) restrictions on use of trademarks and franchise have been removed: and (vi) dancers, wrestlers and entertainers will not require Reserve Bank permission for making remittances abroad.

22. As per guidelines issued on January 12, 2005 (i) transfer of shares in an existing Indian company has been allowed under automatic route except in (a) financial sector and (b) where the provisions of Securities and Exchange Board of India
(substantial acquisitions of shares and takeover) regulations are attracted; (ii) conversion of ECB/loan into equity has been allowed under the automatic route provided the activity is covered under the automatic route and the foreign equity after such conversion falls within the sectoral cap; and (iii) conversion of preference shares into equity has been allowed under the automatic route provided the increase in foreign equity participation is within the sectoral cap in the relevant sectors and the activity is under the automatic route.

23. In a phased manner, RBI has liberalized limits on the overseas investment by companies from 200 per cent to 400 per cent of their networth. This is due to the reason that many Indian companies are now acquiring large companies overseas.

The problem of capital account convertibility was revisited in 2006, with expanded contours. The performance of Indian economy in past nine years (1997-2006) played a critical role in generating confidence among policy makers to wind back the Tarapore Committee Recommendations, with further modifications. In 2004, India became one of the fourth richest economies of the world in terms of purchasing power parity (PPP) index. Despite stringent capital controls, India's performance of capital account was stunning in terms of stupendous increase in non-debt capital inflows. This motivated India to go for full capital account convertibility to seek better access to international capital and achieve better integration of the Indian economy into the world economy.

The Prime Minister, Dr Manmohan Singh in a speech at the Reserve Bank of India, Mumbai, on March 18, 2006, also advocated the capital account convertibility and urged the RBI to draw up a roadmap for this. To quote:
"Given the changes that have taken place over the last two decades, there is merit in moving towards fuller capital account convertibility within a transparent frame.... I will therefore, request the Finance Minister and the Reserve Bank to revisit the subject and come out with a roadmap based on current realities”.


Dr. Y.V. Reddy, the then Governor of the Reserve Bank of India (RBI), in consultation with the Government of India, appointed a committee under the chairmanship of the same Shri S.S.Tarapore on March 20, 2006, for setting out a roadmap towards Fuller Capital Account Convertibility.

The terms of reference of the Committee were:

1) To review the experience of various measures of capital account liberalization in India.

2) To examine implications of fuller capital account convertibility on monetary and exchange rate management, financial markets and financial system.

3) To study the implications of dollarization in India of domestic assets and liabilities and internationalization of the Indian rupee.

4) To provide a comprehensive medium term operational framework, with sequencing and timing, for fuller capital account convertibility taking into account the above implications and progress in revenue and fiscal deficit of both centre and states.

5) To survey regulatory framework in countries which have advanced towards fuller capital account convertibility.

6) To suggest appropriate policy measures and prudential safeguards to ensure monetary and financial stability, and
To make such other recommendations as the Committee may deem relevant to the subject (Report on Fuller Capital Account Convertibility, 2006).

The Committee submitted its report to the RBI on July 31, 2006.

Taking lessons from cross country experiences in fuller convertibility on capital account, the committee suggested a number of pre-conditions for the success of capital account liberalization in India. These included a strong macroeconomic framework, sound financial systems and markets and prudential regulatory and supervisory architecture.

It detailed a broad five year frame for movement towards fuller convertibility in three phases:

Phase II (2007-08 to 2008-09).
Phase III (2009-10 to 2010-11).

It recommended the meeting of certain indicators/targets as a concomitant to the movement towards fuller convertibility of the rupee on capital account. These included:

1. Meeting FRBM targets; shifting from the present measure of fiscal deficit to a measure of the Public Sector Borrowing Requirement (PSBR);

2. Segregating Government debt management and monetary policy operations through the setting up of the Office of Public Debt independent of the RBI;

3. Imparting greater autonomy and transparency in the conduct of monetary policy; and slew of reforms in banking sector including a single banking legislation and reduction in the share of Government / RBI in the capital of public sector banks;
4. Keeping the current account deficit to GDP ratio under 3 per cent; and

5. Evolving appropriate indicators of adequacy of reserves to cover not only import requirements, but also liquidity risks associated with present types of capital flows, short-term debt obligations and broader measures including solvency.

Some of the significant measures to be implemented in a sequenced manner as for the given roadmap included:

1. Raising the overall external commercial borrowing (ECB) ceiling as also the ceiling for automatic approval gradually;

2. Keeping ECBs of over 10-year maturity in Phase I and over 7-year maturity in Phase II outside the ceiling and removing end-use restriction in Phase I;

3. Monitoring import-linked short-term loans in a comprehensive manner and reviewing the per transaction limit of US $ 20 million;

4. Raising the limits for outflows on account of corporate investment abroad in phases from 200 per cent of net worth to 400 per cent of net worth;

5. Providing Exchange Earners Foreign Currency Account holders access to foreign currency current/ savings accounts with cheque facility and interest bearing term deposits;

6. Prohibiting FIIs from investing fresh money raised through Participatory Notes (PN), after providing existing PN-holders an exit route so as to phase them out completely within one year;

7. Allowing non-resident corporates (and non-residents) to invest in the Indian stock markets through SEBI-registered entities including mutual funds and portfolio management schemes who will be individually responsible for fulfilling know your customer (KYC) and Financial Action Task Force (FATF) norms;
8. Allowing institutions/corporates other than multilateral ones to raise Rupee bonds (with option to convert into foreign exchange) subject to an overall ceiling which should be gradually raised; linking the limits for borrowing overseas to paid-up capital and free reserves, and not to unimpaired Tier I capital, as at present, raising it substantially to 50 per cent in Phase-1, 75 per cent in Phase II and 100 per cent in Phase III;

9. Abolishing the various stipulations on individual fund limits and the proportion in relation to net asset value;

10. Raising the overall ceilings from the present level of US$2 billion to US$3 billion in Phase I, to US$4 billion in Phase II and to US$5 billion in Phase III; raising the annual limit of remittance abroad by individuals from existing US$ 25,000 per calendar year to US$ 50,000 in Phase I, US$ 100,000 in Phase II and US$ 200,000 in Phase III; allowing non-residents (other than NRIs) access to Foreign Currency Non-Resident (FCNR(B)) and Non-Resident (External) Rupee Account (NR(E)RA) schemes.

Thus, since the early 1990’s, the Indian economy has been moving progressively towards integration into the global economy. The rupee is now fully convertible on the current account and considerable progress has been made in making it convertible on the capital account. However, the movement on the capital account convertibility have been rather slow and cautious. India believes that full convertibility on capital account is a process rather than a single event.

In the field of international trade the basic objective of policy changes has been the creation of an environment for achieving rapid increase in exports, raising India’s share in world exports and making exports an engine for achieving higher economic
growth. The focus of these reforms has been on liberalization, openness, transparency and globalization with a basic thrust on outward orientation (Economic Survey, 2001-02). Major elements of these reforms have included the substantial reduction in import duties, and a drastic rationalization of tariff structure, dismantling of non-tariff barriers, measures to ensure adequate and timely availability of bank credit for trade finance at competitive interest rates, an appropriate institutional arrangement for supporting a vigorous export drive (For further details see Chapter 4).

Trade reforms have also encompassed a vast range of tradable services. In view of the growing importance of the service sector in Indian economy, India's stance towards General Agreement on Trade in Services (GATS) has changed considerably. India has a comparative advantage in Mode 1 and Mode 4 type of services and has displayed keenness in pushing its interests with the other member nations.

Reforms in external sector have also included foreign investment. To-day FDI is regarded as something that needs to be promoted rather than permitted. Almost all sectors of the economy have been opened up to FDI. The foreign ownership cap has been raised to 100 percent in most of the sectors. FDI is encouraged through a very liberal but dual route: a progressively expanding automatic route and a case by case route (For further details see Chapter 5). As a result FDI inflows have accelerated considerably. Portfolio investments are restricted to select players particularly approved institutional investors and NRI's.

Indian companies are permitted to access international markets through GDRs/ADRs under an automatic route subject to specified guidelines.

Foreign investment in the form of Indian Joint Ventures abroad is also permitted.
Restrictions on outflows involving Indian Corporates, banks and those who earn foreign exchange (like exporters) have also been liberalized over time subject to certain prudential guidelines.

The period since reforms has also witnessed redesigning of policies concerning External Commercial Borrowings (ECBs).

3.4 Concluding Remarks

To conclude, the years after 1990-91 have witnessed some far reaching changes in the approach to and conduct of India's economic policy. The basic objective underlying the changes in policy has been to put the Indian economy on a sustainable path of high growth by freeing the economy from the state intervention either in the form of planning mechanism or various types of controls. The changes have fallen broadly under two categories: macroeconomic reforms and structural adjustments. The first group of measures have been directed at short term stabilization aiming at inflation control and wiping out of the balance of payments deficits. This is a short run facet of economic reforms focusing on demand management through reduction of fiscal deficits, rationalization of subsidies and cutting down of government expenditure. The second set of measures have dealt with structural reforms and directed towards long run improvements in the supply side of the economy. The programme has been more wide ranging and involved all vital sectors of the economy.
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