GS FOUNDATION FOR CSE 2024

ECONOMY-25

EFFECTS OF LIBERALIZATION ON THE ECONOMY

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2. SYLLABUS: EFFECTS OF LIBERALIZATION ON ECONOMY

3. PYQS

- Examine the impact of liberalization on companies owned by Indians. Are they competing with the MNCs satisfactorily? Discuss [Mains 2013]

- How has globalization led to the reduction of employment in the formal sector of the Indian economy? Is increased informalization detrimental to the development of the country? [Mains 2016]

4. LIBERALIZATION

Economic Liberalization refers to reducing government regulation in economic activities and allowing market forces in determining economic activities.

5. THE ORIGIN OF ECONOMIC CRISIS IN THE EARLY 1990S

- Early 1991 saw the emergence of a major economic crisis in India. Economists consider it the biggest challenge that Indian economy has ever faced since independence.
- **Key Reasons**:
  - » **Imprudent macro management of the Economy:**
    1. **High Fiscal Deficit**: It deteriorated throughout 1980s due to growing burden of non-development expenditure and reached 7.8% in FY91.
       - » **Very high growth of government expenditure** but lack of investments in capital.
       - » **PSUs were not generating profits** due to efficiency issues.
       - » **Critical infrastructures** were facing delays due to PSUs being the dominant players.
       - » **Restrictive Trade and Industrial Licensing Framework** led to serious loss of efficiency reducing the scale of output, eliminating effective competition, and creating bottlenecks.
    2. **Large Current Account Deficit:**
       - » CAD had reached $9.7 billion or 3.69% Of the GDP in FY91.
    3. **High Internal as well as External Debt**:
       - » The fiscal deficit was financed using borrowings, the internal debt of the central government increased rapidly, rising to **49.7% of the GDP** in FY91.
         - This also increased the burden of debt servicing. Interest payments reached 3.8% of the GDP and 22% of the total central government expenditure in FY91.
       - » **Increasing CAD** had to be financed using borrowings from abroad. This resulted in external debt rising to **23% of the GDP** in FY91.
       - » The **BOP position** was on the brink of disaster as in Mid-Jan 1991 and again in late June 1991 the level of Forex reserves were not sufficient to finance imports of even 10 days.

4. **High Inflation**: Rate of inflation reached 10.3% in FY91, and food prices increased drastically Inspite of three consecutive good monsoon in a row.
    - **Reasons**: Monetization of fiscal deficit and thus excessive increase in money supply. This liquidity overhand along with supply demand imbalances led to very high inflation.

- **Other Factors:**
    - **Political Instability** in the country at this juncture
    - **Gulf Crisis**: The increase in prices of crude oil led to mounting.
    - **Collapse of Soviet Union** which was India's major trading partner.
    - **Decline sovereign credit rating**: All the above factors contributed to declining confidence in India's economy leading to decline in credit rating of the economy.

6. ECONOMIC REFORMS IN INDIA

- It is generally agreed that the process of Economic Reforms was initiated in India by the government of P.V. Narasimha Rao in 1991 with the announcement of a number of measures for Liberalization of Economy by the then finance minister Dr. Manmohan Singh.

- However, **Arvind Panagariya** has argued that the process was started in the second half of 1980s during the prime ministership of Rajeev Gandhi.
    - Rajeev Gandhi had brought '**New Economic Policy**' which moved Indian economy towards increased outward and inward competition by the end of 1980s.
    - However, not being able to predict how the electorate might react, the politicians were still afraid to announce their conversion openly.

- **However,** the **reforms introduced in 1991-92** were substantially big.
    - These measures were complete renunciation of the old policy framework and brought **liberalization out in open**. It is precisely because of this reason in most of the studies on Indian economy, the process of economic reforms is assumed to have started in 1991.

1) KEY COMPONENTS OF ECONOMIC REFORMS

The process of economic reforms initiated by Dr P.V. Narsimha Rao government consisted of **two distinct strands**: **Macroeconomic stabilization** and **Structural Reforms**. While stabilization deals with demand management, structural reforms deal with sectoral adjustments designed to tackle the problems on the supply side of the economy.

2) MACRO-ECONOMIC STABILIZATION

- **Macroeconomic Stabilization (**often just referred as stabilization) involves returning to low and stable inflation and a sustainable fiscal and BOP position.
    - Stabilization is necessary to overcome a crisis, but it assumes a special importance if structural reforms are also introduced together with stabilization. (**class discussion)**

- **The macroeconomic stabilization** program adopted by the government consisted of the following components:
  1. **Inflation Control:**
     - The rate of inflation in FY91 was around 10%. This could be brought down by introducing fiscal and monetary discipline and by improving the output and supply situation. It seems. That government's achievement was modest on both the fronts. Overall, the average inflation remained at 10.7% for three years after reforms due to high fiscal deficit and rise in administered prices.
     - But, now with flexible inflation targeting by RBI, situation is much better.

  2. **Fiscal Consolidation:**
     - Fiscal deficit in FY91 was at 8%. Through, a program for fiscal adjustment it was brought below 5.5% in FY92 and FY93. But it rose again. It was eventually, the FRBM Act, 2003 which led to fiscal deficit declining to 2.5% in FY08. It rose again due to requirement of fiscal stimulus during 2008 financial crisis and then in FY19 & FY20 due to structural reforms and COVID-19 crisis.
     - **How to do fiscal consolidation** (Already covered with Budget chapter)

  3. **Improving BOP**:
     - Forex reserve increased from a modest $2.2 billion in FY91 to more than $600 billion in FY22.
       - **Exchange Rate Reforms**:
         - Rupee was devalued twice in July 1991 leading to a 20% depreciation in its value (one of the conditions by IMF – to get rupee to its market value)
         - This was followed by Liberalized exchange rate management (LERMS) in the budget of FY93.
           - Under this system a dual exchange rate was fixed under which 40% of foreign exchange was to be surrendered at the official rate while the remaining 60% was to be converted to market determined rate.
         - Budget 1993-94 adopted the **Unified Exchange rate system** and has been in operations since then. The experience with the system has been **satisfactory** as the period since 1993 has been marked by orderly conditions in forex market, except a few episodes of volatility.
           - The exchange rate management policy of the RBI in this period has been '**managed float regime**' i.e. RBI has focused on managing volatility with no fixed target while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly way. This policy has withstood the test of time by ensuring a judicious mixture of 'flexibility' and 'pragmatism'.
         - For current account, rupee has been made fully convertible.
     - In FY92, CAD was reduced to 0.4% in FY92 due to import compression which in turn adversely affected the overall performance of the economy.
     - Liberalization reforms from FY92, further led to worsening of CAD crisis.

3) STRUCTURAL REFORMS

Since July 1991 comprehensive **liberalization measure**s have been undertaken to improve the **supply-side of the economy**. Most important reforms on this side are (i) Trade and Capital Flow Reforms (2) Industrial Deregulation; (3) Disinvestment and Public enterprise reforms (4) Financial Sector Reforms. According to Montek Singh Ahluwalia, "*it is the structural reform component that signaled a paradigm shift in the way the economy was to be managed*". The earlier suspicion of the private sector and of the market gave way to a new **emphasis of freeing the creative energies of the private sector** by allowing it to respond to market forces.

A) TRADE AND CAPITAL FLOW REFORMS

TRADE POLICY REFORMS:

Since July 1991, the government has introduced a series of reforms in the trade sector which are aimed to **help integrate Indian economy better with the rest of the world**.

- **Currency Reforms**:
  - The system of fixed exchange rates was abandoned in India in Sep 1975 and since then system of **managed exchange rate float** has been in operation.
  - In July 1991, government formally **devalued rupee by 18-19%** to restore India's international competitiveness.
  - Introduction of convertibility of rupee first on trade account and then for the entire current account transactions;
- **liberalization of import regimes**
  - **Gradual reduction in tariffs**: Budget 1991-92 reduced peak rate of import duty from more than 300% to 150%. In phased manner this was reduced to 10% by 2007-08 budget.
    - Over the past few years, existing system of impot duties have been considerably rationalized with the purpose of establishing a parity in prices of goods produced domestically and internationally.
  - **Decanalization** of several export and import items in the last two decades.
    - This opened more areas of external sector to private sector.
    -

NN	**Canalization**: Under this system exports and imports used to be canalized through public sector agencies.

  - Dismantling import licensing system
  - Removal of quantitative restrictions;
- **Focus on Increasing Exports**: Government has also introduced a number of export promotion measures in recent years.
  - This include establishment of **Export Oriented Units** for promoting exports from the agricultural and allied sectors; Simplification of Export Promotion Capital Goods Scheme; introduction of Export Promotion Capital Goods Scheme for service sector; setting up Special Economic Zones (SEZs); Creation of Exporters' Grievance Cell in the ministry of commerce.

CAPITAL FLOW REFORMS:

- **The Capital Issues Control Act** was repealed, and **SEBI was set up as a watch dog for regulating the function of the capital market**.
- **In Sep 1992**, the government announced guidelines for investments by foreign institutional investors (FIIs) in the capital market.
- **FDI has been liberalized** making India one of the most attractive destinations for FDI in the world.

B) INDUSTRIAL DE-REGULATION

- Though some liberalization and streamlining of industrial policy was affected in mid-1980s, the **New Industrial Policy (NIP)** announced on 24th July 1991 and subsequent amendments brought far reaching changes in the policy regime governing industrial investments:
  - The NIP **dismantled the industrial licensing (or approval) system** in all sectors except five specified industries.
    - These included alcohol, cigarettes, hazardous chemicals, industrial explosives, and electronic aerospace and defence equipment (all types). These sectors need to be regulated in view of environmental hazards, National Security and social well-being consideration.
  - **Number of Industries reserved for Public Sector** has been reduced from 17 to 2. These two sectors are atomic energy and railways.
    - Now core industries like iron and steel, electricity, air transport, shipbuilding, heavy machinery etc. and even strategic industry like defence production have been opened for the private sector.
  - **Foreign investment has also been liberalized** over the years. Automatic approvals have been made available to almost all industries except those subject to public sector monopoly and industrial licensing.
  - **Monopoly and Restrictive Trade Practices Act** has now been scrapped.
    - The act had prevented many firms from growing to optimum size and thus achieve higher efficiency levels.
    - This scrapping allows industrial units to grow to optimum size and enjoy the benefits of economy of scale.
  - **Phased Manufacturing Program** under which domestic manufacturers were required to increase the domestic input-content of their products in a specified period has also been abolished under the new industrial policy.

C) PUBLIC SECTOR REFORMS AND DISINVESTMENT

- **Background**: PSUs were expected to be the engine of self-sustained economic growth in India. It was also expected to hold the commanding heights of the economy and to lead to technological advancements. Over the years, PSUs have played an important role in expansion and diversification of industrial base. But they also **suffered from various challenges**. They failed to generate sufficient internal resources for its further expansion and, as a result, has now become a major constraint on economic growth.
- **Reforms**: Under structural reforms government is doing the following things:
  a. **Giving managerial autonomy** to PSEs to enable them to work efficiently.

b. **Promotion of increased private sector competition** in areas where social sector considerations are not paramount.
c. **Partial disinvestment of equities** in selected entities.

D) FINANCIAL SECTOR REFORM

- **Introduction**: A vibrant, efficient and competitive financial system is necessary to support structural reforms in the real economy. To Achieve this, government had set up Committee on Financial System in 1991 and Committee on Banking Sector Reforms in 1998 (Narsimhan Committees)

- **Report of Narsimhan Committee on Financial Safety** became the basis for **introducing reforms in banking sector**:
  a. The government has over the years **brought down SLR and CRR** in a phased manner.
    - **Current SLR stands around 18% and CRR around 4.5%.**

  b. RBI has also introduced prudential norms in respect of income recognition, classification of assets, provisioning of debts and capital adequacy.
    - For e.g. now all banks' groups have CRAR much higher than minimum 9% stipulated by the RBI.

  c. Commercial banks who fulfill prudential accounting norms and capital adequacy norms have **freedom to set up new branches** without the approval of the RBI.
  d. **Permission to new private sector banks** (including foreign joint ventures)
  e. RBI has also announced **guidelines for setting up banks in the private sector.** These banks should be financially viable and should avoid concentration of credit and cross holdings with industrial groups.
  f. **Interest rates in the banking system** has been liberalized, compared to situation prevailing before 1991.
  g. **Supervisory role of RBI has been strengthened** by setting up of a new Board for Financial Supervision under the chairpersonship of Deputy Government of RBI.
  h. **Agreement** between RBI and PSBs have been made to improve management and the quality of the performance of latter.
  i. Initiatives like **SARFAESI Act and IBC** have improved recovery of the banks.

- Another committee - **Committee on Banking Sector Reforms under the chairmanship of M Narsimhan** submitted its reforms in 1998.
  » It stressed on measures like Increase in CRAR; stricter NPA norms; and provisioning requirements and the introduction of asset liability management guidelines; depoliticized bank boards under the RBI supervision; allow set up of foreign banks etc.
  » In line with these recommendations' government took following steps:
    - Raising CRAR to 9%.
    - Strengthening Prudential accounting norms
    - Laying down Asset Liability Management (ALM) and Risk Management guidelines.
    - In 2002, SARFAESI act was passed; in 2016, Insolvency and Bankruptcy Code (IBC) was introduced to improve the recovery of banks.

  » Some of the committee's recommendations which haven't been implemented are:
    - Country should have **2 or 3 large banks** with international orientation.

        - Strong banks should be merged, and relatively weak and unviable ones should be closed.
    - Bank Recapitalization is not viable and should be abandoned.
        - Weak banks should be closed.

4) IMPACT OF LIBERALIZATION

- **The liberalization** of Indian economy has had significant impact on country's economic growth and development:
    i. **Higher growth in reform period**:
        - The rate of GDP growth which used to be 3.4% in 1960s and 1970s and 5.2% in 1980s rose to 5.9% in 1990s and further to 7.6% in the first decade of the present century.
        - Correspondingly, the rate of growth of per capita GDP also increased substantially and was as high as **6.0%** per annum in the first decade of the century.
    ii. **Economic Growth Rate increased**: India's economic growth between 1992 – 2000 was 5.7% much higher than the GDP growth rates of previous years.
    iii. **Investment including FDIs and FIIs** increased.
    iv. **Service Sector growth**: new sectors like BPO, IT etc. boomed in India creating more service exports and more jobs in the country.
    v. **Expansion of Private sector** – Privatization of many PSUs and deregulation of various sectors, paved the way for various industries to thrive.
    vi. **Improved Quality of good and services**: With liberalization and globalization, Indian industries had to compete with foreign countries, eventually leading to improved quality of goods and services and thus improved competitiveness.
    vii. **Lower Inflationary Pressure**: Removal of inefficiencies and increased competition led to reduction in inflationary pressure on the economy.
    viii. **Reduction in Poverty**: The growth resurgence enabled India to move up in the per capita (PPP-corrected) GDP ranking from 93 (out of 109 countries) in the mid-1970s to 58 in 2004.

- **But**, at the same time Liberalization has also led to some challenges:
    » **Growth has not been inclusive:**
        - **Impact of reforms on the poor people** has been negligible and there is hardly any change in their abysmal living conditions.
            - **Low rate of increase** in average per capita expenditure and real wages.
            - **Income Inequality and Regional Disparities are increasing**:
                - **E**.g., as per a recent report by Oxfam, India's top 1% owned more than **40.5%** of its total wealth in 2021.
    » **Jobless Growth:** In the post reforms period, while the growth rate accelerated, the jobs failed to increase. Infact the quality of existing jobs has also deteriorated, with the percentage of workers in the informal sector increasing.
    » **Neglect of education, skilling and healthcare**: This has led to development of low employment potential.
        - The economic reforms ignored education, skilling and healthcare. So, while the macro-economic stabilization and structural reforms were achieved, human development suffered.

- **Widespread malnutrition and under-nutrition**: The 2021 Global Hunger Index Report ranked India 101/135 countries with a score of 27.5.
  - Economists Dreze and Sen say "While there is much scope for debate about different ways of measuring undernourishment, what is not in doubt is that ***India still has a higher proportion of undernourished children than almost any other country in the world***.
- **Increased vulnerability to global economic** crisis due to increased linkage to global economy.
- **Agriculture and other small-scale sectors** have faced increased challenges due to global challenges and decreased incentives and subsidies for them.
- **The Question of sustainability of growth**: Environmental Pollution and Climate Change have emerged as a major challenge to sustainability and the economic reforms have only exacerbated these challenges. Unlike other problems discussed above, this is a global problem and has to be dealt at global level with each country having its contributions.

- **Conclusion:** To become a prosperous and high-income country in the next two decades, India will have to achieve economic growth rate that is superfast (growth rate of 8% or more) and inclusive (growth that is widely shared. The 1991 economic reforms have played their role and improved the fundamentals of Indian economy. It is now time for another round of radical reforms to keep the engine of productivity growth firing on all cylinders.

7. DEVELOPMENT OF INDIAN ECONOMY: TRANSITION FROM AGRICULTURE TO SERVICE SECTOR

- **Share of the three sectors in Economy:**

Year	Agriculture	Industry	Services
1947	55%	15%	30%
2022-23:	17%	29%	54

- The above table shows that in the 75 years of India's independence, Indian economy has moved from a primarily agricultural economy to an economy where service sector has the biggest contribution.
- In this period, Industrial sector has never been the major contributor in the economy and its share has remained stuck around 30%. This is unique as economies generally, in their process of development, transition from agriculture sector to industrial sector before actually.
- This is unique as all over the world, economies first transition from Agriculture to Industrial sector, before services start contributing bigger share.
- **Factors for this jump from Primary Sector to Tertiary Sector**:
  - **Why manufacturing sector suffered?**
  - **Colonial Legacy**: The British rule destroyed the industrial base of India and had made it a primarily raw material supplying economy.
  - **Infrastructure Challenges in India**: Industrial growth requires good quality of roads, storage, electricity supply etc. But governments since independence were not able to focus on these challenges.
    - Logistics cost in India remains much higher than the global average hampering the competitiveness of India's economy.

        - India's Port and Shipping sector remained inferior for a long period due to inefficiencies of trusts which manage these major ports.
        - Electricity supply has remained a concern even today, with many areas seeing a power cut regularly, hampering growth of industries.
    - **Complicated Labor laws**: Manufacturing sector is generally labor intensive sector and complicated labor laws in the country hindered businesses from scaling their factories.
    - **Complicated tax regime**: The corporate tax in India before the 1991 reforms was as high as 50%. This discouraged businesses from penetrating into manufacturing.
    - **Scarcity of Land**: India has very high population density and thus land acquisition has always been a problem. Service sector may start on small land areas. But, to set up large manufacturing bases, large areas of land needed to be acquired which has been very difficult in India.
    - **Red Tapism, Over-regulation, license raj** etc. before the 1991 economic reforms hindered manufacturing sector. Some of these problems persist even today hampering ease of doing business in India.
    - **Various challenges faced by MSME sector**: MSME sector contributes a large share of manufacturing in India. But this sector suffers from several challenges including lack of excess to finance, old technology, lack of skilled workforce, poor branding and marketing etc.

- **Why Service sector's contribution kept on improving (why service sector leapfrogged)?**
    - Service sector did better vis a vis manufacturing sector and its share in the economy leapfrogged due to following reasons:
        i. **Globalization, Information Technology and English-Speaking workforce**:
            - The time when economic reforms were taking place, India's IT sector was also emerging. Economic reforms led to IT sector/BPOs etc find easy markets abroad.
            - Further, the labor requirement here was much lesser and India's higher education system was producing people with required skills and English-speaking ability in enough numbers.
        ii. **Very Small Entry Barriers**: One could start an IT company with few computers and servers and then scale with time. This isn't the case with manufacturing sector, which to remain competitive have to produce things at large scale.
        iii. **Flexible and Scalable nature** of the service sector allowed companies to quickly respond to market dynamics, making them more resilient to economic fluctuations.
        iv. **Changing Consumer Needs**: With economic growth in India, increased the demand for services like better education and health facilities, more financing requirements etc.

- The above advantages for service sector along with the bottlenecks faced by the manufacturing sector led to the leapfrogging of service sector in India compared to manufacturing sectors.

- **PYQ**:

    Normally countries shift from agriculture to industry and then later to services, but India shifted directly from agriculture to services. What are the reasons for the huge growth of services vis-a-vis industry in the country? Can India become a developed country without a strong industrial base? [Mains 2014, 12.5 marks, 200 words]