PHASE III (1981–88): LIBERALIZATION BY STEALTH

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Scheme of Presentation

- Introduction
- The political context
- Deregulation of Industry
- Trade Liberalization
- Foreign Investment and Technology Import
- Other Reforms

Introduction

- By 1975, Mrs. Gandhi had implemented the key components of the Ten-Point Program.
- All major banks, insurance companies, oil companies, and coal mines had been nationalized.
- With some exceptions, foreign companies were in the process of being brought under the purview of FERA, 1973, which required most of them to lower foreign equity to 40 percent and to register in India as Indian companies.

Introduction

- Activity of big business houses and large enterprises were governed by MRTP Act.
- Entry and expansion of firms came to be governed by a series of lists subject to a complex web of rules.
- Industrial performance during the first half of the 1970s was dismal (2 percent per annum during 1970–75).
- In international trade, all imports were subject to licensing and strict foreign exchange control.

Introduction

- This performance led some relaxation of controls after the first oil price crisis.
- As a result, the second half of the 1970s saw some piecemeal deregulation of industry.
- The process gained momentum in the 1980s, especially after Rajiv Gandhi became the prime minister.
- As a result, the liberalization during this period was done quietly, as if by stealth.

POLITICAL CONTEXT

- In 1980 the general elections returned Mrs. Gandhi to power with a two-thirds majority in the Parliament.
- This time she was a changed prime minister, more pragmatic and less dogmatic, and she had no socialist agenda to push.
- Indeed, the only significant step in this direction was the nationalization of six more banks, the initiative for which came from RBI Governor I. G. Patel.

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POLITICAL CONTEXT

- The available evidence suggests that within broadly defined parameters, Mrs. Gandhi listened to her advisers and gave them space within limits.
- In June 1984, Mrs. Gandhi ordered the Indian Army to enter the Golden Temple, where a group of militant Sikhs was fortified. Thousands of innocent Sikh pilgrims died in the operation. In retaliation, two of Mrs. Gandhi's own guards assassinated her on October 31, 1984.

POLITICAL CONTEXT

- Rajiv Gandhi succeeded her. In the elections that followed soon after, he won a resounding victory with a three-fourths majority in the Parliament.
- He was India's first modern prime minister who had mostly grown up in an independent India. He was freer of the socialist baggage and less fearful of being subject to dependence on the world markets than his predecessors.
- Unsurprisingly, he implemented a program of economic liberalization and introduced many important reforms in the first two years of his rule.
- He also improved relations with the United States.
- In 1989, V. P. Singh succeeded Rajiv Gandhi as PM of India.

DEREGULATION OF INDUSTRY

- Three phases of industrial deregulation (each more significant than the preceding one) can be identified. The first set of measures was taken during 1975-79, the second set during 1979-84, and the final set during 1985-89.
- The majority of the steps during the first period were taken in 1975 and 1976, and can be summarized as follows
- Under *diversification* provisions, firms in several engineering industries were permitted to change the mix of products within the existing capacity. But because the firms were not permitted to install new machinery to achieve the desired adjustment, the measure could have only limited impact.

DEREGULATION OF INDUSTRY

- *Recognition of capacity* over and above the licensed capacity on the basis of such considerations as modernization, export performance, increased efficiency, and rationalization of shifts. The underlying idea was to reward the firms that exported or were able to increase output through modernization, increased efficiency, or rationalization of shifts.
- Automatic capacity *expansion* up to 25 percent of the licensed capacity in 15 selected engineering industries and for establishing new capacity on the basis of "commercial" utilization of results of research and development (R&D) in other industries.

DEREGULATION OF INDUSTRY

- 24 sectors were delicensed, subject to the condition that no import of machinery or raw material or foreign collaboration would be required.
- The asset limit on plant and machinery in the small-scale enterprise was raised from 0.75 million to 1 million rupees.
- The *exemption limit* on investment in fixed assets for capacity expansion by existing undertakings or establishment of production capacity by new undertakings was raised from 10 million to 30 million rupees in 1978.

DEREGULATION OF INDUSTRY

- Mrs. Gandhi returned to power in 1980 as prime minister and quickly moved to set the tone for industrial policy through the Industrial Policy Statement of July 1980.
- In this statement, schemes for capacity expansion and licensing exemption were more generous and wide-ranging, and imposed fewer restrictions in terms of new investment, machinery imports, and foreign exchange.

DEREGULATION OF INDUSTRY

- The main measures were as follows:
- *Regularization* of capacity in excess of licensed levels in 34 key industries, and the exclusion of production for export in the calculation of the licensed capacity.
- Extension of the scheme for automatic capacity *expansion* up to 25 percent of the licensed capacity from the 15 engineering industries to appendix I industries in 1980, and to 45 other new industries in 1982.

DEREGULATION OF INDUSTRY

- Reendorsement of capacity scheme (April 1982): If actual production of an enterprise exceeded licensed capacity by 25 percent in any year, the enterprise was granted a 1/3 increase in its existing licensed capacity.
- Enlargement of the scope for new investment activity by the MRTP and FERA companies through (1) enlargement of appendix I (October 1984), (2) identification of nine industries of national importance that were freed of the MRTP clearance, (3) special incentives for investment in backward areas with no industrial activity, and (4) 100 percent export production units.

DEREGULATION OF INDUSTRY

- Enhancement of the investment limits for exemption from industrial licensing from 30 million to 50 million rupees (1981).
- Machinery imports of 4 million rupees were permitted, and there was no restriction on raw material imports.
- In March 1984, private sector participation was introduced in the manufacture of telecommunications equipment.
- In 1980, the asset limit on plant and machinery in the SSI was raised from ₹1 million to ₹ 2 million.

DEREGULATION OF INDUSTRY

- In 1986, firms that reached 80 percent capacity utilization in any of the 5 years preceding 1985 were assured authorization to expand capacity up to 133 percent of the maximum capacity utilization reached in those years.
- To relax the licensing and capacity constraints on the larger firms, in 1985–86 the asset limit above which firms were subject to the MRTP regulations was raised from 200 million rupees to 1 billion rupees.

DEREGULATION OF INDUSTRY

- As a result, as many as 90 out of 180 large business houses registered under the MRTP Act were freed from restrictions
- The requirement of MRTP clearance for 27 industries was waived.
- 30 industries and 82 pharmaceutical products were delicensed in or after 1985.
- The ceiling on asset size in plant and machinery of SSI was raised from 2 million to 3.5 million rupees in 1985.

DEREGULATION OF INDUSTRY

- The ultimate effect of these liberalizing reforms was seen in the higher industrial growth, which rose to 6.3 percent in phase III, compared with 4.0 percent in phase II.
- Applications for new undertakings by the MRTP firms show an upward trend until 1985.
- The process of approval for new undertakings was speeded up during the period under consideration. The rate of decision in the first year rose from 38.6 percent in 1981 to 53.4 percent in 1986.

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TRADE LIBERALIZATION

- Let us discuss trade liberalization in three board areas: direct import controls, tariffs, and export restrictions
- Direct import controls
- Until 1976, an import policy was issued every six months in the form of the so-called Red Book
- The general framework for import adopted in 1978–79 and was remained in place with some modifications until the major reforms in the 1990s.

TRADE LIBERALIZATION

- The first step toward liberalization was the rationalization of the licensing regime in 1978–79, based on the 1978 report of the P. C. Alexander Committee.
- The Alexander Committee strongly recommended that products not produced domestically be freed from licensing through inclusion in the open general licensing (OGL) list.
- As per the recommendation of the above recommended the long list of imports and the accompanying conditions was replaced by a policy that would divide imports into banned (prohibited items), restricted (permission required), and OGL lists (freely importable).

TRADE LIBERALIZATION

- All consumer goods were in the restricted list where as intermediate goods and capital goods were either in banned list or in OGL.
- Imports of several items remained the exclusive monopoly of the government through the "canalizing agencies". For example, crude oil and petroleum products were canalized through the Indian Oil Corporation. In 1987, there were 16 canalizing agencies in existence.
- At least three features of the industrial and technology policies served as non-tariff barriers to imports.

TRADE LIBERALIZATION

- First, under the so-called Phased Manufacturing Program (PMP) accompanying the license, a firm agreed to progressive indigenization of the product. This involved replacing the imported components with domestically sourced ones produced in-house or by other Indian firms.
- Second, the Capital Goods Committee had the power to reject applications that in its view involved excessive foreign exchange outlay.
- Finally, the technology import policy reviewed for the foreign exchange requirements for the payment of rovalties and license fees bv the firms.

TRADE LIBERALIZATION

- As a result of the above policy, first, the share of the canalized imports declined. Between 1980–81 and 1986–87, the share of canalized imports in total imports fell from a hefty 67 percent to 27 percent.
- Second, the OGL list, which was reintroduced in 1976 with 79 capital goods items on it expanded steadily, reaching 1007 in April 1987, 1170 in April 1988, and 1329 in April 1990.
- Third, several export incentives were introduced or expanded, which helped increase imports directly when they were tied to exports (Replenishment licenses).

TRADE LIBERALIZATION

- **Tariff**
- The period under consideration was characterized by steep tariff escalation, especially after 1984–85: the change in tariff revenue as a percent of imports, which rose from 27 percent in 1977–78 to 62 percent in 1987–88.
- **Export Incentives and Restrictions**
- Many exports were subject to licensing. Objectives behind the controls included keeping domestic prices low

TRADE LIBERALIZATION

- Exports of certain items were also canalized.
- On the incentives side, three schemes were most crucial: REP licenses, duty drawback, and the Cash Compensatory Scheme (CCS).
- REP licenses allowed the exporter to import some of the non-OGL raw materials and components on the restricted, limited permissible and canalized lists.
- The license holder would pay normal customs duties, which would then be refunded through the duty drawback scheme.

TRADE LIBERALIZATION

- In addition, the CCS compensated the exporter for other domestic taxes, such as sales taxes.
- During 1985–86 and 1986–87, the government took several measures to promote exports, including the following
  - A passbook scheme for duty-free imports for exporters
  - Increase in the business income tax deduction to 4 percent of net foreign exchange realization plus 50 percent (raised to 100 percent in 1988) of the remaining profits from exports.
  - Reduction in the interest rate on export credit from 12 percent to 9.5 percent

TRADE LIBERALIZATION

- Faster processing of export credit and duty drawbacks
- Upward revision of the rates of the Cash Compensatory Scheme (CCS) for offsetting internal taxes
- Permission to retain 5–10 percent of foreign exchange receipts for export promotion.
- Duty-free capital goods imports for exporters in “thrust” (i.e., targeted) industries.
- Full remission of excise duties and domestic taxes
- Remission of 20 percent of interest charges on Industrial Development Bank of
- India (IDBI) loans for firms exporting over 25 percent of output.

TRADE LIBERALIZATION

- Finally, India also employed export processing zones (EPZs) and bonded manufacturing (100 percent export-oriented units or EOU) schemes to promote exports.
- The first EPZ appeared in the early 1960s, the second in the early 1970s,and the next four in the 1980s.
- The EOU schemes were introduced in 1981.
- While neither of these schemes operated effectively due to heavy customs and regulatory controls.

TRADE LIBERALIZATION

- **The Impact of Liberalization**
- Liberalization, though piecemeal and limited in scope, had a definite impact on imports.
- The available data on imports and import licensing confirm very substantial and steady import liberalization that occurred after 1977–78 and during 1980s.
- Imports outside of canalization and licensing (i.e., those mainly on the OGL) increased from 5 percent of total imports in 1980–81 to 30 percent in 1987–88.

Merchandise Exports and Imports as a Proportion of GDP

Year	Exports/GDP (%)	Non-Oil Imports/GDP (%)	Imports/GDP (%)
1	*2*	*3*	*4*
1972–73	3.7	3.1	3.5
1977–78	5.3	4.4	5.9
1978–79	5.2	4.7	6.2
1979–80	5.3	4.9	7.6
1980–81	4.7	5.1	8.7
1981–82	4.6	5.0	8.1
1982–83	4.7	4.6	7.6
1983–84	4.5	5.0	7.2
1984–85	4.8	4.8	7.0
1985–86	3.9	5.3	7.1
1986–87	4.0	5.6	6.5
1987–88	4.4	5.1	6.3
1988–89	4.8	5.7	6.7
1989–90	5.7	6.0	7.3

FOREIGN INVESTMENT AND TECHNOLOGY IMPORTS

- For purposes of foreign investment, the FERA regime remained largely intact during this period.
- The change was more pronounced toward technology imports, since technological obsolescence was an important concern during the period.
- The IP statement 1980 had provided that “Companies which have well established R&D organization, and have demonstrated their ability to absorb, adapt and disseminate modern technology will be permitted to import such technology as will increase their efficiency and cost-effectiveness.”

FOREIGN INVESTMENT AND TECHNOLOGY IMPORTS

- On foreign equity, exceptions to the 40 percent ceiling were allowed more liberally.
- In 1986, the government decided to allow foreign equity even in existing Indian companies employing superior technology.
- The considerable liberalization of policy in the 1980s caused the average number of approvals [of foreign collaboration] per year to increase from 242 during the period 1967–79 to 744 during 1980–88.
- The increase in the number of financial collaborations per year was even sharper, their proportion in the total approvals increasing from 16.1 percent to 22.8 percent.
- The average value of foreign investment approved per year increased by over 17 times, from Rs. 53.62 million to Rs. 930.84 million.

OTHER REFORMS

- Piecemeal reforms were introduced during this period in virtually all areas.
- We will discus here four of them: distribution and price controls, taxation, telecommunications, and education.
- Price and distribution controls on cement and aluminium were entirely abolished.
- In the taxation area, there was a major reform of the tax system.
- The multipoint excise duties were converted into a modified value-added (MODVAT) tax, which enabled manufacturers to deduct excise taxes paid on domestically produced inputs and countervailing duties paid on imported inputs from their excise obligations on output.

OTHER REFORMS

- In telecommunications, the early reform involved its separation from the P&T Department and the creation of the Department of Telecommunication in 1985. Rajiv Gandhi also ended the government monopoly on the manufacture of telecommunications equipment, and allowed the private sector into it in the mid-1980s. He also opened the first technology park in Bangalore and liberalized imports of electronic equipment.
- In the area of education, the National Policy on Education was announced in May 1986.
- It provided for a large-scale, non-formal education centres program "for school drop-outs, for children from habitations without schools, working children, and girls who cannot attend whole-day schools".

Reference

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Thank you

Series of Lists

- Schedule A of the Industrial Policy Resolution (IPR), 1956 listed industries reserved for the public sector, though the state reserved the right to invite the private sector to cooperate if it saw such cooperation as in the national interest.
- Schedule B of the IPR, 1956 listed industries in which state enterprises were to acquire the dominant role.
- Schedule I of the Industries (Development and Regulation) Act (IDRA), 1951, which was virtually all-inclusive and subjected all investments in fixed assets in excess of 10 million rupees to licensing.
- Appendix I of the press note on industrial policy dated February 2, 1973 listed industries open to the MRTP and foreign companies, provided they were not reserved for the public sector and small-scale units, or subject to special regulations.
- Schedule IV of the press note dated February 19, 973, listed industries in which diversification and substantial expansion were disallowed regardless of the firm's size.
- Schedule I of the same note listed industries reserved for small-scale units.

PHASE IV (1988–ONWARDS): TRIUMPH OF LIBERALIZATION

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- The political context
- The Shifting Consensus
- Growth Spurt and the BOP Crisis
- Triumph of Liberalization: the New Industrial Policy
- Trade Liberalization
- Liberalization in Other Sectors

Introduction

- Experimentation with piecemeal reforms in the 1980s had demonstrated to the policymakers that liberalization could yield improved performance.
- Phase IV began with an unprecedented growth spurt that ended in a balance of payments crisis.
- The response to the crisis was a major liberalization on both the domestic and the external fronts. The economy was successfully stabilized, and growth at the higher rate resumed within a short period.
- The higher growth has been maintained to date, and prospects are good that with some key reforms it can be raised further.

POLITICAL CONTEXT

- Every government since the end of Rajiv Gandhi's term in December 1989 has either been formed by a coalition of parties or survived through support of one or more parties that did not join the coalition but nevertheless supported it except the present government.
- Gandhi's immediate successor was his former finance (and later defence) minister, V. P. Singh.
- Having fallen out of favor with Gandhi, Singh had been expelled from the Congress Party in 1989. Taking a faction of Congress members with him, he joined hands with the Lok Dal and one of the major factions of the Janata Party to form the Janata Dal.

POLITICAL CONTEXT

- In the election Gandhi's Congress Party failed to get a majority.
- This allowed the Janata Dal and a group of smaller parties to form the National Front coalition. Supported from outside by the BJP, the National Front formed the government and Singh came to the helm as prime minster.
- As finance minister in Gandhi's cabinet, Singh had been responsible for the liberalization and reforms during 1985–86 and 1986–87.
- He continued on this path, but internal politics of the National Front brought him down in November 1990. This deprived him of the opportunity to implement the industrial policy of 1990, a major step toward liberalization.

POLITICAL CONTEXT

- Chandra Sekhar was now a member of the National Front succeeded Singh. He, too, failed to hold the coalition together for long, however. His government fell in March 1991 and fresh elections were called.
- During the election campaign, on May 21, 1991, Rajiv Gandhi was assassinated.
- The resulting public sympathy probably helped the Congress Party win enough seats in the Parliament to form a minority government with the support of the Left Front parties.

POLITICAL CONTEXT

- P. V. Narasimha Rao was elected as the leader of the Congress Parliamentary Party and became the prime minister in June 1991.
- The macroeconomic crisis of 1991 had been under way during the elections.
- This presented Rao with the opportunity to undertake major reforms.
- He clearly rose to the occasion and appointed a technocrat, Dr. Manmohan Singh, as the finance minister, and himself held the Ministry of Industry.

POLITICAL CONTEXT

- As industry minister, Rao announced the industrial policy of 1991, which put an end to licensing except in 18 sectors and opened the door to foreign investment much wider.
- As finance minster, Singh took the lead to end import licensing on capital goods and intermediate inputs, and to correct the overvaluation of the exchange rate, a key element in the liberalization strategy.
- He then proceeded to cut the tariff rates, with the top rate falling from 355 percent to 110 percent in 1991–92 and to 65 percent in 1994–95.

POLITICAL CONTEXT

- These reforms gave good results in the first three years of the Rao government but progress slowed down considerably in the last two years of his term.
- But the government had introduced enough liberalizing measures to set the economy on the course to sustaining approximately 6 percent growth on a long-term basis.
- Indeed, during 1993–97, the economy grew at the rate of 7.1 percent. But this economic performance proved insufficient to counter the negative effects of a 10 percent hike in the CPI during 1994–95 and 1995–96 and the corruption scandals that beset his admn.

POLITICAL CONTEXT

- The Congress Party lost the 1996 election.
- In the following three years, India had a series of short-lived governments.
- The BJP, having won the most seats, was invited to form the government and Vajpayee became the prime minister but failed to muster a majority of votes in the Parliament.
- He resigned in less than three weeks.
- The Congress Party and the Communist Party of India (Marxist) agreed to support from outside a new coalition of seven parties known as the United Front. The dominant party in the United Front was the Janata Dal.

POLITICAL CONTEXT

- Deve Gowda of the Janata Dal became the prime minister on June 1, 1996, but was in office less than a year due to differences with the Congress Party leadership.
- Inder Kumar Gujral, also of the Janata Dal, succeeded as a compromise candidate on April 21, 1997, but he, too, lasted less than a year.
- Fresh elections were called and Vajpayee returned as prime minister on March 19, 1998, heading the National Democratic Alliance (NDA), a coalition of several parties led by the BJP.

POLITICAL CONTEXT

- But a year later, AIDMK, a member of the coalition, withdrew support and the government fell and elections were called once again.
- This time around, the election produced a clearer mandate in favor of the NDA, and Vajpayee formed a government on October 13, 1999.
- This government proved stable and served its full five-year term.
- The Vajpayee government proceeded to carry forward the reform agenda in a number of directions, including international trade, foreign investment, insurance, telecommunications, electricity, roads, privatization, and education.

POLITICAL CONTEXT

- The 2004 and 2005 elections the United Progressive Alliance (UPA) came to power with Dr. Manmohan Singh as the PM.
- A remarkable feature of Phase IV (1988–onwards), however, is that despite eight different prime ministers, from Rajiv Gandhi to Manmohan Singh, leading coalitions consisting of parties from far Left to far Right, the reform process kept moving forward.

THE SHIFTING CONSENSUS

- The consensus in favor of the controlled regime among politicians and bureaucrats was beginning to break during the second half of the 1980s.
- The master minds behind this were Rajiv Gandhi and I. G. Patel.
- In his Kingsley Martin Memorial Lecture, delivered in Cambridge, Patel (1987) approvingly described the reforms introduced by Rajiv Gandhi in the preceding one and a half years as the “New Economic Policy.”

THE SHIFTING CONSENSUS

- He first made the point that the consensus in the policy circles within India had shifted considerably away from the controlled regime.
- The consensus that Patel spoke of had moved considerably more toward increased outward and inward competition by the end of the 1980s.
- The little-known Industrial Policy Statement, 1990, provides compelling evidence of the considerable political acceptance that internal and external liberalization had gained at least a year before the balance of payments crisis.

THE SHIFTING CONSENSUS

- PM V. P. Singh, who announced the policy statement on May 31, 1990, lost his mandate in the Parliament on November 10, 1990, before he had a chance to implement it.
- The major changes proposed in the IPS1990 were:
  - The investment ceiling in plant and machinery for SSIs (fixed in 1985) would be raised from ₹3.5 million to ₹6.0 million.

THE SHIFTING CONSENSUS

- All new units, up to an investment of ₹250 million in fixed assets in non-backward areas, and ₹750 million in backward areas, would be exempt from the requirement of obtaining a license.
- Keeping in view the need to attract an effective inflow of technology, investment up to 40 percent of equity would automatically be allowed.
- 100 percent export-oriented units and units to be set up in export-processing zones would be delicensed up to an investment limit of ₹750 million.

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GROWTH SPURT AND THE BALANCE OF PAYMENTS CRISIS

- During the fiscal years spanning 1988–91, GDP at factor costs grew at rates of 10.5, 6.7, and 5.6 percent, respectively. The average of these rates was 7.6 percent, a rate not previously recorded over any continuous three-year period in Indian history.
- Growth was spread across all sectors: 7 percent in agriculture, 9.1 percent in industry, and 7.1 percent in services.
- The explanation for agricultural growth is (i) the continuous spread of the use of the HYV, tractors and fertilizers; and (ii) the mercy of Mother Nature.

GROWTH SPURT AND THE BALANCE OF PAYMENTS CRISIS

- There are two complementary explanations for the higher growth rates in industry and services: liberalization and expansionary fiscal policy combined with foreign borrowing.
- The second of these factors inevitably carried the seeds of a crisis that became a reality in 1991.
- The impact of the more liberal policy regime can also be seen from the outcome variables.
- The gross fixed private investment as a proportion of GDP steadily rose from 10.2 percent in 1986–87 to 11.5 percent in 1987–88, 12 percent in 1988–89, and 13.9 percent in 1990–91.

GROWTH SPURT AND THE BALANCE OF PAYMENTS CRISIS

- On the external front, the merchandise imports-to-GDP ratio rose from 6.3 percent in 1987–88 to 7.6 percent in 1990–91.
- Complementing liberalization in stimulating growth were borrowing abroad and fiscal expansion.
- Throughout the 1980s, India ran large current account deficits and the deficit became particularly large during the second half of the decade.
- From 1980–81 to 1984–85, it ranged between 1.3 and 1.9% of the GDP. In 1985–86, it jumped to 2.4%, fell back to 2% in 1987–88, and then shot up to 3.1% in 1988–89, 2.6% in 1989–90, and 3.4% in 1990–91.

GROWTH SPURT AND THE BALANCE OF PAYMENTS CRISIS

- The rapid accumulation of foreign debt for investment rose from \$20.6 billion in 1980–81 to \$64.4 billion in 1989–90.
- The external debt-to-GDP ratio rose from 17.7% in 1984–85 to 24.5 percent in 1989–90. Over the same period, the debt service ratio rose from 18% to 27%.
- The share of private borrowers in the total long-term debt increased from 28% to 41%.
- The share of non-concessional debt rose from 42% to 54%.

GROWTH SPURT AND THE BALANCE OF PAYMENTS CRISIS

- The average maturity of debt declined from 27 years to 20 years.
- Thus, while external debt was helping the economy grow, it was also moving it steadily toward a crash.
- A similar story was evolving on the internal front.
- While external borrowing helped relieve some supply-side constraints, rising current domestic public expenditures provided the stimulus to demand, particularly in the services sector.

GROWTH SPURT AND THE BALANCE OF PAYMENTS CRISIS

- Defence spending, interest payments, subsidies, and the higher wages following the implementation of the 4th Pay Commission recommendations fuelled these expenditures.
- As with external borrowing, high current expenditures proved unsustainable.
- They manifested themselves in extremely large fiscal deficits.
- Combined fiscal deficits at the central and state levels, which averaged 8% in the first half of the 1980s, went up to 10.1% in the second half.

GROWTH SPURT AND THE BALANCE OF PAYMENTS CRISIS

- Continued deficits of this magnitude led to a build-up of very substantial public debt with interest payments accounting for a large proportion of the government revenues.
- They also inevitably fed into the current account deficits, which kept rising steadily until they reached 3.4 percent of the GDP in 1990–91. The eventual outcome of these developments was the June 1991 crisis.
- The final blow was administered by the decline in the stock of foreign exchange reserves. From an average of 4.6 months' worth of imports during 1984–87, the reserves fell to 3.9 months' worth of imports in 1987–88. The trend continued with a drop in the reserves to 2.5 months' worth of imports in 1988–89, 2 months in 1989–90, and just one month in 1990–91.

GROWTH SPURT AND THE BALANCE OF PAYMENTS CRISIS

- In June 1991, with confidence in the ability of the government to service its external debt completely lost, the crisis reached the doorstep of the country with the downgrading of its credit rating and loss of access to the world financial markets.
- The resolution of the crisis took the form of the IMF entering the scene with a program in July 1991 and the World Bank following with a structural adjustment loan (SAL).
- The IMF program and the World Bank SAL initiated a process of liberalization that has continued to move forward at a gradual pace until today.
- In the intervening years, the policy regime and the economy have been considerably transformed, with the growth rate stabilized at approximately 6%.

TRIUMPH OF LIBERALIZATION: THE NEW INDUSTRIAL POLICY

- The liberalization measures in 1991–92 may be viewed as a continuation of the process that had begun as early as 1975.
- But one key difference sets the 1991–92 liberalization apart from the piecemeal measures preceding it: *Whereas the prior liberalization had been undertaken within the essential framework of investment, import licensing, and price and distribution controls, the 1991 reform abandoned that framework and moved some way toward replacing it with the market mechanism.*

TRIUMPH OF LIBERALIZATION: THE NEW INDUSTRIAL POLICY

- In a single stroke, the statement of industrial policy dated July 24, 1991, did away with investment licensing and myriad entry restrictions on the MRTP firms.
- It also ended public sector monopoly in many sectors and initiated a policy of automatic approval for foreign direct investment up to 51 percent.
- On licensing, the new policy explicitly stated, “Industrial licensing will henceforth be abolished for all industries, except those specified, irrespective of levels of investment.”

TRIUMPH OF LIBERALIZATION: THE NEW INDUSTRIAL POLICY

- The list of industries required licensing was trimmed in the course of time until it was left with only five sectors justified on health, safety, or environmental grounds:
  - (a) arms and ammunition, explosives, and allied items of defence equipment, defence aircraft, and warships;
  - (b) atomic substances;
  - (c) narcotics and psychotropic substances and hazardous chemicals;
  - (d) distillation and brewing of alcoholic drinks; and
  - (e) cigarettes/cigars and manufactured tobacco substitutes.

TRIUMPH OF LIBERALIZATION: THE NEW INDUSTRIAL POLICY

- The new policy also limited the public sector monopoly to eight sectors selected on security and strategic grounds, and listed in annex I. All other sectors were opened to the private sector.
- In subsequent years, annex I has been trimmed, with only railway transportation and atomic energy remaining on it.
- Entry to the private sector has been given even in the manufacture of defence equipment.
- The new policy also did away with entry restrictions on MRTP firms.

TRIUMPH OF LIBERALIZATION: THE NEW INDUSTRIAL POLICY

- In the area of foreign investment, the policy statement abolished the threshold of 40 percent on foreign equity investment.
- The concept of automatic approval was introduced whereby the Reserve Bank of India was empowered to approve equity investment up to 51 percent in the 34 “priority” industries traditionally called “appendix I” industries and now listed in annex III of the new policy.

TRIUMPH OF LIBERALIZATION: THE NEW INDUSTRIAL POLICY

- In subsequent years, this policy was considerably liberalized, with automatic approval made available to almost all industries except those subject to public sector monopoly and industrial licensing.
- On foreign technology agreements, the policy introduced automatic permission in high priority industries up to a lump-sum payment of ₹10 million, and 5 percent royalties for domestic sales and 8 percent for exports, subject to total payment of 8 percent of sales over a ten-year period from the date of the agreement or seven years from commencement of production. Subsequently, the policy was extended to other industries.

TRADE LIBERALIZATION

- **Merchandise Trade Liberalization**
- The July 1991 reforms did away with import licensing on all except a handful of intermediate inputs and capital goods items.
- But consumer goods, accounting for approximately 30% of the tariff lines, remained under licensing.
- It was only after a successful challenge by India's trading partners in the Dispute Settlement Body of the WTO that these goods were freed of licensing a decade later, starting April 1, 2001.

TRADE LIBERALIZATION

- Today, except for a handful of goods disallowed on environmental, health, and safety grounds and a few others, including fertilizer, cereals, edible oils, and petroleum products.
- In 1990–91, the highest tariff rate stood at 355 percent; the simple average of all tariff rates at 113 percent; and the import weighted average of tariff rates at 87 percent.
- The top rate fell to 85 percent in 1993–94 and to 50 percent in 1995–96.

TRADE LIBERALIZATION

- Prior to the elections in May 2004, Finance Minister Jaswant Singh had announced reduction of the top tariff rate from 25 to 20 percent and the elimination of the special additional duty that could be as much as 4 percent.
- The succeeding government did not reverse these changes. Indeed, it lowered the top tariff rate to 15 percent in 2005–06, 12.5 percent in 2006–07, and 10 percent in 2007–08.
- There remain exceptions to this rule, however. For example, the customs duty on automobiles remains in the neighbourhood of 100 percent.

TRADE LIBERALIZATION

- Likewise, several textile items remain subject to duties exceeding 10 percent.
- Nevertheless, the decline in customs duties is pronounced: Customs revenue as a proportion of merchandise imports was only 4.9 percent in 2005–06.
- But prior to the July 1991 reforms, exports of 439 items were subject to controls, including (in declining order of severity) prohibition (185 items), licensing (55 items), quantitative ceilings (38 items), canalization (49 items), and pre-specified terms and conditions (112 items).

TRADE LIBERALIZATION

- The March 1992 export-import policy reduced the number of items subject to controls to 296, with prohibited items reduced to 16.
- The process continued subsequently, so that export prohibitions currently apply to a small number of items on health, environmental, or moral grounds; export restrictions are maintained mainly on cattle, camels, fertilizers, cereals, peanut oil, and pulses.
- As a part of the 1991 reform, the government devalued the rupee by 18 percent against the dollar, from ₹21.2 to ₹25.8 per dollar.

TRADE LIBERALIZATION

- In February 1992, a dual exchange rate system was introduced, which allowed exporters to sell 60 percent of their foreign exchange in the free market and 40 per cent to the government at the lower official price.
- Importers were authorized to purchase foreign exchange in the open market at the higher price, effectively ending the exchange control.
- Within a year of establishing this market exchange rate, the official exchange rate was unified with it.

TRADE LIBERALIZATION

- Starting in February 1994, many current account transactions, including all current business transactions, education, medical expenses, and foreign travel were permitted at the market exchange rate. These steps culminated in India's accepting the IMF article VIII obligations on August 20, 1994, which ***made the rupee officially convertible on the current account***.
- In recent years, the accumulation of a large stock of foreign exchange reserves, India has freed up many capital account transactions.
- Two provisions are of special significance: (1) residents can remit up to $25,000 abroad every year; and (2) firms can borrow freely abroad as long as the maturity of the loan is five years or more.

TRADE LIBERALIZATION

- **Trade in Services and Foreign Investment**
- Traditionally, key services sectors like insurance, banking, and telecommunications have been subject to heavy government intervention.
- But since 1991, India has carried out a substantial liberalization of trade in services via freeing up foreign investment and opening the door wider to private sectors.
- The current foreign investment regime in India operates on “negative list philosophy,” meaning that unless there are specific restrictions spelled out in the FDI policy, up to 100 pe rcent foreign investment, subject to the sectoral rules and regulations, is permitted under the automatic route.

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TRADE LIBERALIZATION

- Four exceptions apply to 100 per cent foreign investment under the automatic route:
  - In four sectors, FDI is prohibited outright: retail trading (except single-brand product retailing), atomic energy, the lottery business, and betting and other forms of gambling.
  - Foreign equity share in excess of 24 per cent in the manufacturing of items reserved for the small-scale sector requires prior government approval.
  - Prior government approval is required when the foreign investor has an existing joint venture or technology transfer/trademark agreement in the same field.
  - The FDI policy lists 28 sectors that are subject to sector-specific policies and sectoral caps on foreign investment that may or may not go up to 100 per cent.

TRADE LIBERALIZATION

- With respect to the last item, the following sectoral caps apply:
  - 20 percent on FM radio
  - 26 percent on up-linking a news and current affairs TV channel; defence production; insurance; public sector refineries; air transport services (100 percent for NRIs); and publishing of newspapers and periodicals dealing with news and current affairs.
  - 49 percent on asset reconstruction companies; three broadcasting subsectors including a cable network; and companies investing in infrastructure and services except telecommunications

TRADE LIBERALIZATION

- 51 percent on single-brand retailing
- 74 or 100 percent on all others, including banking, nonbanking finance companies; telecommunications; manufacture of telecom equipment; trading, construction, airports, power, petroleum and natural gas, coal and lignite mining; tea; coffee and rubber processing; and special economic zones.

● Taken as a whole, India now has a foreign investment policy that is approximately as open as that of China.

● Even in the retail sector, back-door entry has been permitted recently whereby foreign retail companies such as Wal-Mart can supply supermarkets owned by Indian companies.

LIBERALIZATION IN OTHER SECTORS

- India has made remarkable progress in reforming the policy regime in areas such as taxation, the financial sector, telecommunications, electricity, the airline industry, and national highway construction.
- Some success has also been achieved in privatization under the NDA government, but the process has slowed down considerably under the UPA government.
- While these reforms have been introduced, India has maintained a relatively stable macroeconomic environment.

Reference

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Thank you