

PAPER I - INDIAN ECONOMY & INDIAN FINANCIAL SYSTEM

Module A: INDIAN ECONOMIC ARCHITECTURE

Chapter 7: Economic Reforms

Topics in this chapter

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- Economic Transformation - Financial Sector,
- Economic Transformation - Integration with the Global Economy,
- Economic Reforms in India

7.1 ECONOMIC REFORMS

Economic reforms are **changes made by the government in the economic policies, rules, and regulations of a country** to improve efficiency, growth, and stability of the economy.

Generally, 'economic reform' means **deregulation**, which is the removal or reduction of government rules and controls. The idea is to remove distortions in the economy that have been caused by too much regulation or government presence. This allows market forces to operate more freely and is aimed at fostering private sector development.

7.2 A BRIEF OVERVIEW



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Economic reforms in India were aimed at expanding the participation of the private sector in the country's growth process. These changes happened in two main phases:

1. **The 1980s Reforms:** These were influenced by the renowned '**Washington Consensus**' doctrine, which is a set of pro-market policy ideas. The changes in the 1980s were very limited and involved only partial liberalization of a few parts of the old regulatory system.
2. **The 1990s Reforms:** The reforms that started in the early 1990s were much broader and deeper, covering areas like industry, commerce, investment, and agriculture.

The major economic reforms were implemented in India in **1991**. This was not a proactive choice but a response to a severe economic crisis. The main causes of this crisis were:

- The poor performance of public sector units.
- A sharp drop in foreign exchange reserves.
- Large government debts.
- The strict conditions laid down by the World Bank and the International Monetary Fund (IMF) for providing loans.

7.3 TRANSFORMATION

The green revolution and industrial modernization have transformed India's economy from a slow-growing one to one of the world's fastest-growing economies. The term '**new economic reforms**' refers to the policies put in place by the Indian government in 1991. The three main pillars of this change were known as **LPG**:

- Liberalisation



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- Privatisation
- Globalisation

The main goals of these reforms were to achieve high economic growth, lower inflation, reduce the current account deficit, and solve the balance of payments problem. Policy changes were made in areas like technology advancement, industrial licensing, removal of restrictions on the private sector, foreign investments, and foreign trade.

Attracting significant **Foreign Direct Investment (FDI)** was one of the key goals of the 1991 economic reform process. India's economic transformation has successfully reduced poverty across all socioeconomic groups and improved the country's capacity in agriculture and industrial production.

7.4 ECONOMIC TRANSFORMATION - REAL SECTOR

The economic changes introduced in India in 1991 were the result of a severe economic crisis caused by rising external debt. This crisis was mainly a consequence of poor economic management in the 1980s. The reforms were broadly known as the LPG reforms.

- **Liberalisation** Liberalisation was based on the idea that regulations on trade must be relaxed for trade to flourish. It led to the opening of India's economic frontiers to international investors and multinational companies. Key reforms under Liberalisation included allowing companies to enhance their production capacity, abolishing government industrial licensing for most industries, and providing the liberty to import goods.
- **Privatisation** Privatisation refers to giving the private sector more opportunities to manage various services while limiting the role of the public sector. This invited more foreign participation and FDI flow into



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India, providing healthy competition to Indian goods and services and improving efficiency.

- **Globalisation** In the context of economic reforms, globalisation refers to the **integration of the Indian economy with the global economy**. It means that India's economy will now be more dependent on the global economy, and vice versa. It encourages FDI and international trade with various countries. Through globalisation, India was able to attract foreign capital, technology, and knowledge to boost its domestic capacity.

7.5 ECONOMIC TRANSFORMATION - FINANCIAL SECTOR

Until the 1990s, the Indian financial sector was heavily controlled. It was characterized by controlled interest rates, a large portion of bank resources being reserved for the government, and extensive micro-regulations.

The primary goal of the reforms was to create an **efficient, productive, and competitive** financial services industry. To guide this process, the government formed several important committees, including:

- The Narsimham Committee-I on Financial Sector Reforms (1991)
- The Narsimham Committee-II on the Review of Banking Sector Reforms (1997)

First Phase of Reforms - The Narasimham Committee I (1991) To improve the health and efficiency of commercial banks, the government appointed a committee under the chairmanship of M. Narasimham. Based on its recommendations, the RBI issued new guidelines on **Income Recognition, Asset Classification, and Provisioning**. These new standards forced the



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banking sector to focus on credit risk and recovery management. Some of the important reforms of this phase were:

- Introduction of Capital Adequacy Norms.
- Progressive reduction of the Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR).
- Deregulation of Lending Rates.
- Establishment of Debt Recovery Tribunals (DRTs).
- Implementation of a Strong Supervisory System.
- Allowing the entry of New Private Banks.

Second Phase of Reforms - Narasimham Committee-II (1997) This committee was set up to review the progress of the reforms and to chart a program to make the Indian financial system internationally competitive. The key benefits of this phase were:

- Deregulation of Branch Licensing.
- Stricter Prudential Norms and Disclosure Requirements.
- Higher Capital Adequacy standards.

The following points are important milestones of the banking sector reforms, categorized by their nature:

1. Prudential Reforms

- These reforms included the phased implementation of international best practices to lower the risk of the banking system.
- Key measures included risk-weighted capital adequacy requirements, proper accounting norms, and limits on how much banks could invest in sensitive activities.



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- The main focus was on three areas: (i) Non-Performing Assets (NPAs), (ii) Capital Adequacy, and (iii) Diversification of operations.

2. Supervisory Reforms

- The **Board for Financial Supervision** was established as the apex supervisory authority.
- The **CAMELS** supervisory rating system was implemented (C-Capital adequacy, A-Asset quality, M-Management, E-Earnings, L-Liquidity).
- A transition to **risk-based supervision** and consolidated supervision of financial groups was made.
- Corporate governance was strengthened with "fit and proper" tests for bank directors.

3. Competition Reforms

- Before the reforms, Indian banking was uncompetitive and inefficient.
- Reforms allowed Public Sector Banks (PSBs) to raise capital from the stock market (up to 49% of paid-up capital).
- **New private and international banks** were permitted to operate in India to foster a culture of competition and give customers more choice.
- Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI) were permitted in the financial sector.

4. Market Reforms

- Administered interest rates were removed, and rates became market-determined.
- CRR and SLR rates were sharply reduced from their previously high levels.



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- A pure inter-bank call money market was established.
- The **Liquidity Adjustment Facility (LAF)**, which operates through repo and reverse repo auctions, was introduced for short-term liquidity management.

5. Institutional and Legal Reforms

- New institutions were established to facilitate faster recovery of bad loans. These included **Lok Adalats**, **Debt Recovery Tribunals (DRTs)**, and **Asset Reconstruction Companies (ARCs)**.
- The **Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act** was passed to protect creditors' interests.
- The **Credit Information Bureau (CIBIL)** was established for information exchange on borrowers.
- The **Insolvency and Bankruptcy Code (IBC), 2016** was enacted, which has had far-reaching implications for the banking sector.

6. Technology Reforms

- **INFINET** was established as the communication backbone for the financial sector.
- **Real-Time Gross Settlement (RTGS)** and **National Electronic Fund Transfer (NEFT)** systems were implemented.
- The use of ATMs, cards, internet banking, and mobile banking has completely changed the face of Indian banking.
- **Direct Benefit Transfer (DBT)** has changed the way cash subsidies are transferred, with the help of technology.

7. Debt Market Reforms



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- An auction system for price discovery in government securities was introduced.
- Foreign Institutional Investors (FIIs) were allowed to invest in government securities.
- The **Clearing Corporation of India Limited (CCIL)** was set up to act as a central counterparty for payments and settlement.

Foreign Exchange Market Reforms

- The most significant reform was the transition from a single-currency, fixed-exchange rate system to a **market-determined floating exchange rate system**.
- The Indian rupee was made convertible for current account transactions.
- The old **Foreign Exchange Regulation Act (FERA)** was replaced with the new **Foreign Exchange Management Act (FEMA), 1999**.

Insurance Sector Reforms

- The **Insurance Regulation and Development Act** was passed in 1999, and the **Insurance Regulatory and Development Authority (IRDA)** was created to govern the insurance industry.
- A large number of private insurance companies, often with foreign partners, entered the sector.
- The concept of **Bancassurance** (selling insurance products through bank branches) became popular.

Capital Market Reforms

- The **Securities and Exchange Board of India (SEBI)** was established in 1992 as the regulator for capital markets.



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- The Indian stock market was opened to **Foreign Institutional Investors (FIIs)**.
- Indian companies were allowed to access international capital markets through instruments like **ADRs and GDRs**.
- Other reforms included the establishment of Credit Rating Agencies, the growth of the Mutual Fund industry, and the introduction of rolling settlements.

7.6 ECONOMIC TRANSFORMATION - INTEGRATION WITH THE GLOBAL ECONOMY

After nearly five decades of being isolated from global markets, India began the process of increasing its integration with the global economy in 1991.

- **International trade** (the sum of exports and imports) increased from **15.5%** of India's GDP in 1991 to **44.67%** in 2024 according to World Bank data.
- Net inflows of **Foreign Direct Investment (FDI)** rose from just 0.03% of GDP in 1991 to **2.42%** in 2020 but currently, India's net FDI inflows remain 0.71% of GDP.
- The substantial inflow of foreign investment into India reflects the country's strong economic potential and the implementation of important policy reforms. However, while being broadly beneficial, this increased global integration has also made the Indian economy **more sensitive to external shocks**.

7.7 ECONOMIC REFORMS IN INDIA



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The economic reforms in India were a response to the economic catastrophe of the 1990s. Renowned economist **Jagdish Bhagwati** categorized India's economic failures into three main areas:

1. Strong bureaucratic controls over production, investment, and trade.
2. Inward-looking trade and foreign investment policies.
3. The inefficient functioning of public-sector enterprises.

These long-standing policies had weakened the economy to such an extent that the modest oil shock of 1990 (due to Iraq's invasion of Kuwait) had a disproportionately large impact.

The economic crisis of 1990 can be explained by the following points:

- **Higher Fiscal Deficit:** The government's ever-increasing non-developmental expenditure led to a rise in the fiscal deficit from 5.1% of GDP in the early 1980s to **8.4% in 1990-1991**.
- **Adverse Balance of Payment Situation:** The current account deficit increased from 1.35% of GDP in 1980-1981 to **3.69% in 1990-1991**. The unstable political situation harmed the confidence of foreign creditors, leading to an outflow of NRI deposits. By 1991, India's foreign exchange reserves had fallen to a low of **US\$1.2 billion**, which was equivalent to only **two weeks' worth of imports**. India was on the verge of bankruptcy.
- **High Inflation Rates:** During 1990-1991, the Indian economy experienced double-digit inflation, which skyrocketed to **11.3%**.

In response to this severe crisis, India began its economic reform process on July 23, 1991. These reforms have greatly benefited India in terms of per capita income and economic growth. International investors' growing trust in



the Indian economy is a result of these significant policy reforms and the liberalization of foreign investment laws.



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