# PAPER I - INDIAN ECONOMY & INDIAN FINANCIAL SYSTEM

## Module A: INDIAN ECONOMIC ARCHITECTURE

## Chapter 7: Economic Reforms

### Quick Revision

**7.1 & 7.2: Introduction to Economic Reforms**

- **Definition:** Economic reforms are changes made by a government to its economic policies and regulations to improve efficiency, growth, and stability. This often involves **deregulation**, which means reducing government controls to allow market forces to operate more freely.
- **Context in India:** The major economic reforms in India were launched in **1991** in response to a severe economic crisis.
- **Causes of the 1991 Crisis:**
  - A high **fiscal deficit** (8.4% of GDP).
  - A severe **Balance of Payments** problem, with foreign exchange reserves falling to a low of US$1.2 billion, enough for only two weeks of imports.
  - Poor performance of **public sector units**.
  - High **inflation** (over 11%).

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**7.3 & 7.4: The LPG Reforms of 1991** The reforms of 1991 were built on three main pillars, collectively known as **LPG**:

1. **Liberalisation:** This involved relaxing government rules and regulations to open up the economy. Key measures included abolishing the

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industrial licensing system for most industries and allowing companies the freedom to import goods and expand production.

2. **Privatisation:** This refers to giving a greater role and more opportunities to the private sector while limiting the role of the public sector. This was done to improve efficiency and attract foreign investment.
3. **Globalisation:** This involved integrating the Indian economy with the global economy. It encouraged foreign trade and Foreign Direct Investment (FDI), allowing India to access foreign capital, technology, and knowledge.

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**7.5: Economic Transformation - Financial Sector Reforms** The financial sector was a key focus of the reforms. The process was guided by the recommendations of the **Narasimham Committees I (1991) and II (1998)**.

**Key Banking Sector Reforms**

- **Prudential Reforms:** Introduced international best practices to manage risk, including new norms for **Income Recognition, Asset Classification, and Provisioning** to tackle Non-Performing Assets (NPAs), and risk-weighted **Capital Adequacy** requirements.
- **Supervisory Reforms:** Established the **Board for Financial Supervision** and implemented the **CAMELS** supervisory rating system.
- **Competition Reforms:** Allowed the entry of **new private and foreign banks** to increase competition and gave Public Sector Banks (PSBs) permission to raise capital from the stock market.
- **Market Reforms: Deregulated interest rates**, allowing them to be determined by the market. The **CRR and SLR** were sharply reduced, and the **Liquidity Adjustment Facility (LAF)** was introduced for managing short-term liquidity.

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- **Institutional and Legal Reforms:** New institutions were created for faster recovery of bad loans, including **Debt Recovery Tribunals (DRTs)** and **Asset Reconstruction Companies (ARCs)**. Major laws like the **SARFAESI Act (2002)** and the **Insolvency and Bankruptcy Code (IBC, 2016)** were enacted.
- **Technology Reforms:** Implemented a modern payment and settlement system with the introduction of **RTGS and NEFT**, and promoted digital channels like ATMs, internet banking, and mobile banking.

**Other Financial Sector Reforms**

- **Foreign Exchange Market:** India shifted from a fixed-exchange rate system to a **market-determined floating exchange rate**. The restrictive **FERA** law was replaced by the more liberal **Foreign Exchange Management Act (FEMA), 1999**.
- **Insurance Sector:** The sector was opened to private and foreign players. The **Insurance Regulatory and Development Authority (IRDA)** was established as the regulator, and the concept of **Bancassurance** (selling insurance through banks) became popular.
- **Capital Market:** The **Securities and Exchange Board of India (SEBI)** was established in 1992 as the capital market regulator. The stock market was opened to **Foreign Institutional Investors (FIIs)**.

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**7.6: Economic Transformation - Integration with the Global Economy** The 1991 reforms successfully integrated India with the global economy.

- **International trade** (exports + imports) grew significantly, from 15.5% of GDP in 1991 to over 44% today.
- **Foreign Direct Investment (FDI)** inflows increased substantially, reflecting global investors' confidence in the Indian economy.
- This increased integration, while beneficial, has also made the Indian economy more sensitive to global shocks.

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