CHAPTER - IV

The Indian Varying Macroeconomic Policy Regimes

4.1 INTRODUCTION

There are many dimensions to economic policy formulations. Macroeconomic policy is obviously a major determinant of the real growth of an economy. Their role relatively varies from short- to medium- to long-run, as they cause changes in the intensity of use of resources, and the efficiency within which they are used. It also influences the level of investment to change, which being the main determinant of long-run growth for an economy. Fiscal, monetary, trade and exchange rate policies are predominantly demand management policies, which are judged by the short- to medium-run success within which they are applied to maintain internal and external stability as to whether keeping inflation within tolerable limits. However, it is most often seen that their plausible longer-run effects on investment in macroeconomic growth process.

There are some point of differences between macroeconomic stabilization policy and structural policies. Macroeconomic stability requires a better coordination between them. The conduct of any government policy is influenced by the spirit of times, as reflected in the intellectual climate and socio-political and economic milieu. The economic policy of a nation is crucial to understand its macroeconomic performances. This is particularly true for a country like India where a highly interventionist government is seen to have followed a complex set of economic policies in a wide variety of areas and sectors since independence. Indian economy has over the studied sample period undergone through varying macroeconomic policy regime, and changes in emphasis placed on different elements in implementing domestic and external sector policies in response to various economic and political shocks. The objectives of macroeconomic policy have long included the avoidance of protracted recessions wherein resources remain under-utilised and of periods of unsustainable growth that can jeopardise reasonable price and exchange rate stability. Thus in order to place the present study in correct perspective, it is necessary to understand India's changing macroeconomic policy trends since independence. To that end, this section provides an introduction to the macroeconomic policies

prevailing in India since dates back to independence. And as its part, fiscal, monetary, exchange rate, industrial, financial, trade policies have in turn independently been discussed into various sub-sections in this chapter. The intent here is not to give a detailed account of Indian economic policies and instead to highlight comprehensively the important features of its varying policy regime.

4.1A FISCAL POLICY

In macroeconomics, fiscal policy consists of a mix of budgetary instruments that government can use to target macroeconomic objectives, in particular stabilisation and growth. Its main components are revenue, expenditure and borrowing. It comprises government expenditure to help achieve its goals and revenues from taxes (direct taxes – mainly corporation and household income tax; indirect taxes – excise and customs) and non-tax sources (mainly from public sector enterprises). The main components of current expenditure are government expenditure behind defense, subsidies and interest. The rise in interest payments is partly consequent to higher interest rates but is mainly due to the rise in the debt. The current revenue balance is the savings of the government. The other side of government expenditure is government capital expenditure. Government fiscal deficit is financed by total borrowing requirement inclusive the borrowing from the central bank. Fiscal deficit less interest payments is primary deficit, which is the balance of revenue and expenditure, which is in principle under control unlike interest payments, which is the result of past transaction. Fiscal policy instruments relate to direct taxes to influence effective demand.

If government spends more than its revenue collection, the gap has to be financed either through money creation or borrowing (from domestic or foreign sources). Money creation could, in turn lead to higher inflation than is desirable. If fiscal deficit is financed through excessively by domestic borrowing may lead to a debt trap and debt management may be unsustainable due to high interest rate / inflation trap and falling private investment. Similarly, over reliance on external borrowing can cause appreciation of the real exchange rates, widening current account deficits, unsustainable foreign indebtedness and dwindling foreign exchange reserves. But given the prevalence of the government sector in the economy – as a corollary of the process of planned economic development the policy variables usually in analysis happens to be the government's current consumption expenditure and capital formation.

The most significant advancement in the methodology in fiscal policy in India seemed to have occurred in the institutionalisation of the concept of fiscal deficit. It is important to note that earlier this concept was notable by its absence from official government documents such as Budgets and Economic Surveys. The concept first appears in the 1989-90 Survey, published in February 1990, stating (p 75): "The central government budget deficit as conventionally defined has fluctuated around 2 percent of GDP in recent years… The conventional budgetary deficit does not indicate the full measure of overall deficit and the government's draft on domestic savings and dependence on external savings. Within a year or two, tables on fiscal deficit and attendant concepts started to have been routine in Budgets and Surveys, the fiscal deficit has been the focus of the macro dimension of fiscal policy in all relevant contexts and had firmly replaced the earlier, more limited concept of budget deficit [Acharya, 2002]. A fuller measure of the overall deficit, which is commonly used internationally, is the difference between government expenditure and net lending on the one hand and current revenue and grants on the other.

This transition seemed to have been accelerated by the IMF programme of the early 1990s which naturally focussed heavily on fiscal consolidation. Another important change that was occurred in the context of fiscal policy was in the shift of central government borrowings to market interest rates. Prior to 1991, the increases in government borrowing programmes were accompanied through hikes in the statutory liquidity ratio (SLR) imposed on commercial banks. By 1990, the SLR had risen sharply to 39 percent [ibid, pp 1533]. This captive market accommodated placement of government securities at sub-market rates and imposed a corresponding tax on financial intermediation by the banks. From 1992-93, government borrowing started shifting to market interests and the SLR was progressively reduced. While this change has not come to help the fiscal accounts, it was an important constituent of financial sector reform. Government borrowing at market rates was also an essential pre-condition for the development of a healthy secondary market in government securities, which, in turn, was an essential prerequisite for the evolution of monetary policy.

In 1994, the central government had a major initiative to curb its hitherto unrestricted access to the Reserve Bank to finance its deficits. Before 1994, the government could unilaterally access RBI financing through the means of 'ad hoc' Treasury bills. Moreover, the government throughout the eighties routinely used this device to meet its requirements for

funds and such monetisation of the deficit became the principal propellant for the expansion of reserve money. Changes in net RBI credit to the central government on average contributed for 93 percent of the variations in reserve money [Rangarajan 1995]. Given that such automatic monetisation of the deficit undermined severally the scope for discretionary monetary policy, the government formalised an agreement with the RBI in September 1994 to phase out 'ad hoc' Treasury Bills over a three year period. The phase out duly occurred and at the end of the three years a new system of ways and means advances was instituted that placed clear limitations on the government's automatic access to RBI financing. It is important to note that this delinking of budget deficits from their monetisation has been a landmark event in India's fiscal/ monetary institutional history. The conditional central assistance in support of agreed programmes of medium term fiscal reform was supported by the recommendations of the Eleventh Finance Commission. At last, in December 2000, the Fiscal Responsibility and Budget Management (FRBM) Bill was later passed in parliament. Amongst its major features include: (a) slash down of the centre's revenue deficit to nil by March 2006, (b) cut down of fiscal deficit to 2 percent of GDP by March 2006, (c) reduction of the ratio of central government liabilities to GDP to 50 percent by March 2011, (d) proportionate cuts in expenditure while there is shortfall of revenue or excess of expenditure over budget targets. FRBM was basically an effort to institutionalise the medium-term process of fiscal consolidation through a legislative mandate.

4.1B MONETARY POLICY

It is not always easy to decouple monetary policy from fiscal policy, financial sector policy and balance of payments policy as they are interlinked to some extent. One of its main aims is stabilisation, growth, and control of inflation adjusting to exogenous shocks and avoidance of policy-mistaken shocks. Besides price, output and employment, it can impact consumption, investment and the balance of payments. The application of monetary policy to promote growth may involve microeconomic issues such as development of banking and financial system, which is beyond the purview of this research.

Since independence monetary policy in India experienced a number of operational and intellectual structural breaks. It is neither entirely contributory to fiscal policy nor heavily constrained by the balance of payments. Though there is an association between fiscal deficits and the supply of money, this can be undermined by instruments at the disposal of the

authorities. The exchange rate is managed as has sometimes been fixed for long periods but exchange controls on capital movements have adequately been effective to permit substantial monetary independence. Monetary policy has several objectives, but the main is to stabilization and growth. Stabilisation refers smooth adjustment to exogenous shocks and avoidance of policy-induced shocks, but as with fiscal policy the variables of interest are not only output and employment but consumption, investment, prices, and the balance of payments as well. It is especially concerned with to achieve the best balance between inflation and economic growth. Its major goal shifted focus to price stability. Inflation targeting has also become the new buzzword for the central banks in many countries. The use of monetary policy to promote growth takes many microeconomic aspects such as the development of an efficient banking and financial system. This sub-section ignores such issues except those interact with the macroeconomic aspects of monetary policy.

The monetary policy instruments in India is wide ranging, embracing both direct (quantity) and indirect (price) approaches. The main direct instruments include reserve ratios, quantitative controls on Reserve Bank lending to banks and the commercial sector, and quantitative credit controls. The indirect instruments work through the administrative setting of various interest rates such as on Reserve Bank lending, commercial bank lending, and deposits. While all these instruments have been available since 1960, the emphasis has changed. In the 1960s, the emphasis was given on indirect measures and there was rarely any variation in reserve ratio. In the 1970s, the emphasis got shifted to direct measures, and this has persisted since then. Among the direct instruments, the priority of variation in reserve ratios has increased considerably compared with variation in Reserve Bank refinance to the commercial sector and quantitative credit controls. Monetary growth in India has been higher in the 1970s and 1980s compared with the 1960s.

From the viewpoint of monetary control, there had been a shift away from indirect to direct approaches in the early 1970s, given the rapid increase in fiscal deficits and the presence of various inflationary pressures. Administratively determined interest rates did have too many conflicting objectives and were rigid to be used for macroeconomic control. There was a tendency to pay as much importance to credit controls on banks as to reserve ratios. By the beginning of the 1980s, the Reserve Bank moved more firmly to money multiplier approach. It is important to note that all the monetary instruments in India both direct and indirect operate

through administrative control or fiat. In India, monetary policy witnessed a most notable break since the mid-1980s when the monetary authorities shifted their preferences towards explicit monetary targeting with feedback on the basis of the recommendations made in the Chakravarty Committee Report. However, its recommendations have undergone radical changes in recent years. Since 1991, with the more market oriented system particularly with the interest rates becoming market determined, open market operations has become a genuine instrument of policy with regard to financing of the budget.

The reforms in the institutional framework and operational procedures for monetary policy in the 1990s were even more significant and far-reaching than in the case of fiscal policy. Prior to 1991, the insistent series of high fiscal deficits, the system of administered interest rates and automatic magnatisation of budget deficits (through 'ad hoc') had placed monetary and financial policy in an unsustainable bind. The foremost authority of the period noted [Rangarajan 1994:

> "Until the overall reform process was initiated in 1991, the basic goal of monetary policy was to neutralise the impact of the fiscal deficits……. Monetary management took the form of compensatory increases in the cash reserve ratio (CRR) for banks, controls on growth of commercial credit (mainly to the enterprise sector) and adjustments of administered interest rates".

Basically banks were bound to fund most of the large fiscal deficits as submarket rates to meet the high and rising SLRs imposed, while the rest was essentially accommodated by the RBI through the medium of 'ad hoc' Treasury bills.

Against this backdrop, the key themes in the reform of the institutional framework and operational procedures for monetary policy have been: Phased reduction in the reserve requirement ratios of CRR and SLR; phased liberalisation of interest rates; elimination of direct credit controls; development of money and financial markets, beginning with those for government securities and bills; restraints on automatic monetisation of budget deficits; activation of open market operations (OMO) by RBI to influence liquidity; policy focus on inter-linkages across various segments of financial markets; restoration of the bank rate as a signalling instrument for monetary policy. These major themes have been pursued with considerable success throughout the decade. The shift of new central government borrowing to market interest rates through auctions from April 1992 was a crucial prerequisite for the

development of government securities markets, without which RBI could not conduct open market operations. This shift was successful to place all primary issues in the market without significant development on RBI, despite a substantial reduction in the SLR. The need for undertaking open market operations felt very sharply with the surge in foreign capital inflow in 1993-94. Since late 1994, the earlier fiscal considerations in monetary policy have taken a back seat following the agreements to cap and to eventually abolish ad hoc Treasury bills. In view of the growing reliance on auctions of government debt instruments, the interest rates are now being influenced mainly by market forces. Increased capital flows have reasonably influenced the liquidity aspect of the financial markets. In this way, the open economy consideration in the conduct of monetary policy more fundamentally shifted the emphasis from the quantity variables (monetary aggregates) to opportunity cost variables (rate of interest and exchange rate) to understand the channels through which transmission mechanism operates in formulating an appropriate monetary policy stance of trying to reduce inflation and interest rates. It is important to note that increased play of market forces in the determination of interest rate and exchange rate may have changed the monetary transmission process [Ray, Joshi and Sagar, 1998].

The use of OMO and repos developed over the course of the decade with the RBI expressing a clear preference for these 'indirect' instruments of monetary management over 'direct' changes in reserve requirements (CRR). OMO and repos have come to the fore as preferred instruments of monetary control. By 1997, interest rates had substantially been liberalised. In 1998 and 1999, the bank rate was effectively deployed to signal the stance of monetary policy and influence prime lending rates of banks. By the spring of 1999, monetary policy had evolved to establish an informal corridor for short-term interest rates, with the fixed repo rate providing the floor and the bank rate the ceiling [Reddy, 1999]. The evolution in the transmission mechanism has been co-ordinated greatly by the abolition of 'ad hoc' Treasury bills and the institution of the new system of limited ways and means advances (WMA) since 1997. But the progress has been disrupted by the series of large and growing fiscal deficits since 1997-98. Though the abolition of 'ad hocs' has cut the automatic link between deficits and monetisation, the problem has not solved yet.

The 1990s saw some evolution in the ultimate objectives of monetary policy. Until at least the middle of the decade, official pronouncements continued to stress the twin objectives

of growth and price stability. Apart from these two important objectives, there appeared third objectives, which has been a conscious attempt on the part of the Reserve Bank in recent years to maintain orderly conditions in the foreign exchange market. From the period of the Chakravarty Committee Report [Reserve Bank 1985] to 1997-98 the annual growth in broad money(M3) had held sway as the sole as an explicit intermediate target of monetary policy. With the liberalisation of financial markets in the 1990s and the increasing importance of external economic transactions, situations have changed. In 1998-99, RBI announced in favour of a 'multiple indicator approach', which would cover interest rates, exchange rate and other variables. In reality, M3 appears to continue as the single most important intermediate target. But its exclusivity has clearly been lost.

The conceptualisation and exercise of monetary policy has clearly undergone a sea change during the 1990s. Major institutional reforms carried out. New institutions and operational procedures established and strengthened. The array of instruments of monetary policy has effectively been broadened. The complexity of market interactions recognised. The efficacy of monetary policy continues to be constrained by an excessively loose fiscal policy as well as an insufficiently responsive financial system.

The environment of liberalisation initiated in the early 1990s following the advent of financial reforms and growing integration of financial markets shift in the operating procedure of monetary policy and monetary transmission mechanism to understand money market disequilibrium situation as interest rate and exchange rate have been the two key variables in the conduct of monetary policy and their joint significance has been important to understand the relationship between money, prices and output. The increased cross-border capital flows added an altogether new dimension to the conduct of monetary policy which now has to operate in open-macroeconomic framework, where interest parities increasingly play an important role in determining monetary and exchange rate relationships. This is supported by presence of a framework, which is characterised by a distinct opposition to government budget deficits and the wide current account gaps in recent years. Monetary policy indeed has recognised these aspects by being increasingly raised issue in terms of empirical validity.

4.1C EXCHANGE RATE POLICY

Over the more than last six decades since independence, the exchange rate regime in India has transited from a Par Value System (1947-71) of the IMF during the pre-Bretton Woods system of gold standard during the 1950s and the 1960s to a Basket Pegged Regime (1971-92) during the 1970s and the 1980s under the Bretton woods system and its era to an end and eventually culminating in the present form of a Market - Determined Exchange Rate Regime since March 1993 (1993 to present day) via a transitional phase of a dual exchange rate between March 1992- February 1993 of Liberalised Exchange Rate Management System (1992-93), whereby the rupee's external par value was revised downwards from 4.15 grains of fine gold fixed after gaining independence to 2.88 grains and 1.83 grains, respectively following the devaluation of the rupee in September 1949 and June 1966. And in terms of currencies, the exchange rate of the rupee which had historically been linked to pound sterling was fixed at Rs. 13.33 per pound sterling (or Rs. 4.76 per US dollar) in September 1949, which remained unchanged up to June 1966 when the rupee was devalued by 36.5 percent to Rs. 21 per pound sterling (or Rs. 7.50 per US dollar), that remained constant till 1971 when the suspension of the convertibility of the US dollar brought the era of Bretton Woods to an end [Patnaik, Kapur and Dhal, 2003].

Acquired a certain dynamism the exchange rate management during the 1980s in the context of macroeconomic policies for the external sector and the exchange rate as a policy instrument was actively used to achieve a sustainable current account deficit to ensure improvements in the price competitiveness of exports and consequently the period started from 1983-84 was marked by continuous downward adjustment in the external value of the rupee [Rangarajan, 1998]. By the late 1980s and the early 1990s, however, recognised both macroeconomic policy and the structural factors had contributed to a misalignment in the exchange rate. Despite exports recorded higher growth during the second half of the 1980s, the current account deficit, however, widened driven by internal imbalances and exchange rate misalignment. The weaknesses of the external sector were triggered by the Gulf crisis of 1990 and the capital flows also went dried up. The Reserve Bank, thus, came to effect a two-step sharp downward adjustment in the exchange rate of the rupee on 1 and 3 July, 1991, which effectively translated into a devaluation of the order of 18-19 per cent in the external value of the rupee to counter the massive draw down in the foreign exchange reserve losses, to restore confidence in the investors and to improve domestic competitiveness. Not the depreciation of

the rupee, however, was an isolated event but was an integral part of an overall structural and stabilisation programme to reform India's external sector policies [Rangarajan, 1991].

The transition to a market-determined exchange rate was the key institutional reform which was essentially important for both macroeconomic management and structural reforms in the first-half of the 1990s. India went to a unified, market-determined exchange rate by March 1993 and to full current account convertibility by August 1994 and there has been little change in the institutional framework for India's exchange rate policy. And, there has been a great deal regarding RBI's monitoring the forex market and its linkages with the domestic money market and of the arduous activity of central bank intervention in spot and forward forex markets. Also RBI has, since recent years, evolved a doctrine or view to support its brand of managed floating [Reserve Bank, 2001]. One recent major institutional reform in this area has been the modernisation of the legal framework brought about by the passage of the Foreign Exchange Management Act (FEMA) in December 1999. Its provision came into effect in June 2000 and replaced the earlier Foreign Exchange Regulation Act (FERA). FEMA involves current account convertibility as a base and allows for progressive liberalisation of the capital account. The shift in emphasis to adopt more flexible and market based exchange rate arrangements is reflected by a variety of factors including the changing economic conditions and policy objectives over time, the liberalisation and globalisation of financial market, accompanying increase in capital mobility and the emergence of tension between objectives of lower inflation and external competitiveness.

4.1. D FINANCIAL SECTOR POLICY

Financial intermediation in India was promoted after independence and more rapidly after the nationalisation of major 14 banks in 1969. In the 1950s and 1960s, the Indian financial sector had gone through a fairly liberal environment. This was the period that saw the Consolidation of the Reserve Bank of India (RBI) in its role as the agency in charge of the supervision and control of banks. A key feature of the banking sector during the period was that a bulk proportion of bank credit went in favour of industrial sector, especially to the large borrowers, while agricultural sector remained almost deprived in terms of bank credit. Thus, there felt an increasing realisation among Indian policy makers that there was a need for extensive social

control of the Indian banking system. In July 1969, as its aftermath, 14 of the major commercial banks were nationalised.

The evolution of the Indian financial sector that begun from 1969 can be classified into three distinct sub-periods: first, a period of growing financial repression from the early 1970s to the mid-1980s; second, a sub-period of mild reforms till 1991; and at last, as of 1991, a period of a growing liberalised financial sector. In the first period, the bank nationalisation of 1969 was extended to nationalise six more Indian commercial banks in 1980. Banks had to face growing pressure to lend to the priority sector, comprising agriculture and allied activities, small-scale industry, retail trade, transport operators, professional, and craftsmen. In other words, there was more credit available for small-scale firms, while medium and large firms might have received a lower share of bank credit in the process. The other additive factor may be as there was a growing alternative to the banking sector via the statutory liquidity ratio to finance the ever widening budget deficits of the central government during the 1970s and the 1980s, probably crowding out of bank financing of private investment. The commercial banks were essentially to provide short-term credit to the manufacturing sector, while long-term loans were provided by all-India development banks like Industrial Development Bank of India and Industrial Credit and Investment Corporation of India. These term-lending institutions were dependent highly on the government for resources usually by being heavily subsidised and their allocation of long-term loans to firms was firmly monitored by the government according to plan priorities. The government also controlled the stock markets with regard to pricing, quantum, and timing of new issues.

By the end of the eighties, the Indian financial sector had registered remarkable growth in volume and variety, comprising stock market, mutual funds, NBFCS and other institutions. Nevertheless, the important financial institutions were not only all state owned but also were subject to central direction and controls. Banks enjoyed little autonomy because both lending and deposit rates were controlled until the end of the eighties. Even if, the nationalisation of banks helping spread banking to the rural and hitherto uncovered areas, the monopoly granted to the public sector and lack of competition may have led to growing overall inefficiency and low productivity. However, there was significant growth in the commercial banking system in the country both through the expansion of the geographical coverage and amount of resources mobilised of the social control of the banking sector that have been the result of a strictly

enforced branch licensing policy followed by the RBI(Ministry of Finance 1991). Under this policy, the RBI restricted banks from being to open branches in urban and metropolitan areas and instead, the overwhelming emphasis of branch expansion was mostly to the 'under-banked' districts in rural and semi-urban areas. This led to an increase in bank deposits. Primarily owing to the branch licensing and real interest rate policies, there was a significant financial deepening in the Indian economy in the 1970s.

In the second sub-period, from the mid-1980s, there was a gradual set of reforms in the money markets with meagre or no change in policies relating to the provision of credit to firms in the industrial sector. While social control of the banking sector may have led to growing inefficiency in the financial intermediation process through the expansion of the geographical spread of the banking system. By 1991, India's financial system had become saddled with an inefficient and financially unsound banking sector. Some of the underlying reasons for this are: high reserve requirements, administered interest rates, directed credit, poor supervision, lack of competition and political interference. Though the financial sector reforms seemed to have been initiated in the mid-eighties, but actually began in 1991. Several radical reforms measures introduced as recommended by the Narasimham Committee Report (1991) including reduction of reserve requirements as statutory liquidity ratio was substantially reduced; de-regulation of interest rates on short-term loans (provided mainly by the commercial banks) and on long-term loans (predominantly provided by development banks) in a phased manner since 1992; softening of consortium lending arrangements; introduction of prudential norms such as income recognition, asset classification, provisioning for bad and doubtful debts and capital adequacy; strengthening of bank supervision and improving the competitiveness of the financial system, particularly permitting entry of private sector banks through opening up of the banking sector a part of the structural adjustment programme of 1991. Several reform measures initiated also in the non-bank financial sector in the capital market like substantial deregulation of the stock market especially the operation of new issue market and relaxation of restrictions on the entry of foreign portfolio investors; and free pricing of shares have been introduced with the abolition of the Office of the Controller of Capital Issues in 1991. In the very next year, Securities and Exchange Board of India (SEBI) was empowered with statutory powers. Transparency of stock trading practices has significantly improved as a consequence of the establishment of the National Stock Exchange to compete with the Bombay Stock Exchange. On balance, the

financial liberalisation measures initiated since 1991have led to a relatively easier access to capital markets, both at home and abroad, for firms and may have eased borrowing constraints on their investment decisions during the new policy regime.

Despite there have been significant moves towards redressing financial repression as there has been significant progress in interest rate deregulation, there are still binding restrictions on the progress in developing the debt market as the demand for corporate debt is still constrained by the portfolio restrictions imposed by the government on domestic insurance and provident fund institutions and foreign institutional investors as well. However, the reforms after 1991 have significantly helped to increase foreign exchange reserves and to reduce the inflation rate. The pace of reforms in Indian context has been positive, but slow. It can by and large be stated that a timely and cautious attempt made in liberalising the Indian financial sector, although at a slow pace. Moreover, there have been important lessons for India to be learnt from the South East Asian experiments with financial liberalisation.

4.1E INDUSTRIAL POLICY

The twin influential components of the regulatory framework of industrial development strategy were the Industries (Development and Regulation) Act of 1951 and the Industrial Policy Resolution of 1948, which amended and elaborated later in 1956. The industrial licensing criteria for private industries were under the first piece of legislation, which provided the legal basis for the regulatory system in which industries were to develop. The licensing system introduced three sets of licensing policies to govern almost all aspects of firm behaviour in the industrial sector that were – capacity licensing, monopoly control, and small scale industry reservations. The purview of controlling was not only in the case of entry into an industry and growth of firms, but also for the scale of operation, choice of technology, output or input mix, capacity location and import content. Thus, the government's role did not remain confined to the broad direction of the industrialisation process, and that concerning aspects extended to detailed decisions at the micro level. The principal goal of this Act was to channelize investments in the industrial sector in socially desirable directions.

The Industrial Policy Resolution distinguished industries in the following ways: (i) based on the end use of outputs industries into capital, intermediate, and consumer goods; (ii) according to their ownership, industries into public, co-operative, private and joint; and (iii)

basing on their size of technology, industries into cottage, village, small scale and organised. However, the most important classification was made among industries dividing them into three groups based on the role of the state as was perceived to interplay in each category.

The divisions were: the first one consisted of certain 'commanding height' industries – mostly public utilities, basic and strategic industries – such as defence, heavy industry, most mining, aircraft, air and rail transport, communications and power – that were to be reserved exclusively to the public sector; the second one consisting some industries – mostly heavy industries in-between or either or both category that were to be developed jointly by the state and private initiatives and were to be progressively owned by the state; and the third one comprising mostly consumer goods industries that remained open to private firms.

During the Fourth Plan period (1969-74), the reign of controls was reinforced with the two enactments, namely the Monopolies and Restrictive Trade Practices (MRTP) Act of 1969 and the Foreign Exchange and Regulation act (FERA), 1973. The former instrument tipped to prevent the concentration of economic power and to curb restrictive practices i.e., reservations for the small-scale sector. In 1973, FERA came into force and thus from 1973 onwards the further activities of foreign companies were restricted to a select group of core or high priority industries. FERA required all foreign companies operating in India to register under Indian corporate legislation with up to 40 percent equity. Certain exceptions from the threshold limit of 40 percent were made only for companies opening in high priority or high technology sectors such as tea plantations, or those producing predominantly for exports.

This Act subjected investment and expansion proposals of 'large and or dominant' industrial undertakings with gross assets exceeding a certain threshold to a separate licensing approach over and above the approvals from the government. The FERA was the most important tool in the hands of the government for regulating commercial and manufacturing activities of branches of foreign firms in India and joint stock companies with a foreign equity holding of over 40 percent; most of them were compelled to dilute foreign equity, and foreign branch companies were obliged to Indianise their shareholdings or fold up. This Act stipulated a list of industries where such firms would be permitted to function, and all new investments and substantial expansions required separate approval from the government. Direct foreign investment was strictly controlled under the regulatory framework of FERA of 1973.

The industrial licensing system had also some import control features built into it. The overriding principle behind industrial licensing system together with import licensing framework supplemented by tariff structure, which came to exist from 1956-57 in the wake of foreign exchange crisis and ended by the first half of the 1970s, led to the elimination of the possibility of competition both foreign and domestic, in any meaningful sense of the term. Over the years, as the then designed licensing system became increasingly complex, it led to a wasteful misallocation of investible resources among alternative industries and also deepen the under-utilization of resources within these industries [Bhagwati and Srinivasan, 1975], thus subscribing to high levels of inefficiency in the industrial sector.

However, from 1980 onwards, industrial policy witnessed greater pragmatism with a gradual cautious deregulation of controls, as industrial licensing approval systems were streamlined. During this period, there was some half-hearted process of relaxation of regulation of industry to dilute licensing and capacity expansion. Greater realism in policy making reflected and a degree of flexibility was introduced as the list of industries open to large firms was also broadened and the asset threshold above which firms were subject to monopoly regulation raised from Rs. 200 million to Rs. 1000 million in 1985-86. By the mid 1980s, India had begun to undertake less interventionist policies.

The second half of the 1980s witnessed considerable de-licensing and relaxation of import controls to upgrade the industrial technology. In the second half of the 1980s, import restrictions moved from quotas to tariffs as a first phase of trade reforms. Until 1991, restrictions were the rule and reforms constituted their selective removal according to a 'positive list' approach. But since 1991, absence of restrictions became the rule with a 'negative list' approach taken to their retention.

In 1991, industrial licensing system was abolished for all industries except those five specified for a select list of health, safety or environmentally sensitive industries. The provisions of the MRTP Act relating to growth, merger, amalgamation, and take-over of large business houses were also eliminated. The list of public sector monopoly industries was reduced from seventeen to six on security and strategic grounds, and all other sectors were opened to the private sector.

The Foreign Exchange Regulation Act (FERA) of 1973 was amended with the objective of lifting constraints placed on foreign companies by the FERA. In the area of foreign investment, instead of the threshold of 40 percent of foreign equity investment 51 percent is now 'automatically' approved for a wide range of industries deemed to be of national importance. Foreign investment was opened up in many sectors including export houses, trading houses, hospitals, sick industries, hotels and tourism. Since 1991, there has been substantial liberalisation in the service sectors where the key areas are insurance, banking and telecommunication.

For the first time in the post –war period, the automatic approval of FDI up to 100 percent is permitted in all manufacturing activities including energy sector of power generation in Special economic Zones (SEZs) except those subject to licensing or public sector monopoly. FDI up to 100 percent under automatic route through Foreign Investment Promotion Board (FIPB) is permitted in information technology units including Export Oriented Units (EOUs), Export Processing Zones (EPZs), Special Economic Zones (SEZs), Software Technology Parks (STPs) and Electronics Hardware Technology Parks (EHTPs). India became a signatory to the Convention of the Multilateral Investment Committee Agency (MIGA). Clearly, the industrial policy liberalisation enabled to provide reasonably conducive environment for private sector to diversify and grow. However, certain aspects of the old regulatory framework left remain unresolved in particular, labour laws and bankruptcy procedures that do not allow firms to liquidate their assets easily. One of the important objectives of the current reforms of industrial policy is to remove impediments for efficiency seeking growth.

4.1F TRADE AND PAYMENTS POLICY

These policies are important from the standpoint of their significant effects on the efficiency of resource allocation. The broad objective of trade and payments policies is maintenance of sustainable current account deficit consistent with other objectives such as internal balance, low inflation and high growth. The policy instruments that are used to achieve payments balance are aggregate demand management, use of reserves, official foreign borrowings, controls on private capital flows, trade intervention, and exchange rate policy. Of these the first three are generally examined indirectly or by implication.

To understand the wide sweep of import controls in India, Bhagwati and Desai (1970) in their pioneering study provide the most comprehensive and systematic documentation of the interventionist policies that had come to exist by late 1960s. As they note, general controls on all imports and exports had been prevalent since 1940. Import controls were put in place during the Second World War because government had requisitioned all shipping for military transport. They were relaxed after the independence in 1947 through the expansion of Open General License (OGL) list in a stop-go fashion with the first five-year plan (1951-56) representing a period of progressive liberalisation. But a foreign exchange crisis in 1956-57 put an end to this phase of liberalisation, and comprehensive import controls were brought in and maintained until 1966.

From 1956-57 till the late 1970s, India had a highly restrictive trade regime. The overriding principle behind protective trade regime was to provide protection to domestic industries from foreign competition along with conserving scarce foreign exchange reserves. Generally speaking, depending on the state of the foreign exchange reserves, the sub-periods 1957-62 and 1968-74 have been of severe tightening and the sub-periods 1966-68, 1975-79, and 1982-89 were of moderate relaxation.

However, since independence over the first four decades the overall trade regime of the Indian economy was inward looking. The role of exports as an engine of growth was paid little attention and instead import substitution strategy over a wide area emerged as the basic feature of the foreign trade regime. In fact, it was envisaged that in course of time, as the process of industrialisation-generated demand for imports of certain intermediate inputs, additional consideration in framing import policy was to ensure adequate supplies of inputs to industry. What the underlying envisaged philosophy was that only after building up a large and widely diversified industrial base, export opportunities would follow (Second Five-Year Plan document 1956).

The main instrument of import controls was the import licensing system. The administrative origins of the import licensing system were Imports and Exports Control Act of 1947 and the Import Trade Control Order of 1955.Nearly all imports were under the purview of import licensing or were channelized by public canalising agencies. There was nothing that can be freely imported over the years because a complex system of import licensing was designed

to provide physical allocation of inputs by type of product e.g., raw materials, finished consumer goods, intermediate and capital goods, etc., by type of users such as established importers, actual users, etc, and by categories like banned, restricted and Open General License (OGL).

The objective of this policy was to control the end use of imports and prevent profiteering by intermediaries. The only exceptions were few essential commodities subject to government discretion and listed in the OGL category. The import policy classified capital goods into lists of banned items, restricted items and the OGL category items. For restricted capital goods, those in the OGL could be imported without a license subject to several conditions. The most important feature of these was that the importing firm was to be governed by the actual user rule and had to use the imported item in its own production process and could not sell that imported equipment prior completion of five years without having the permission of licensing authorities so that the resulting change in capacity must remain compatible with the capacity approved by the industrial licensing clearance.

Thus for capital goods, the policy mechanism was designed being dominated by the 'indigenous angle' with blatant neglect of cost and quality considerations. Intermediate goods were classified into the banned, restricted and limited permissible categories plus OGL list. Of these, the names for the first three lists suggest in order of import licensing stringency. OGL imports of intermediate goods were also subject to 'actual user' condition. The import of finished consumer goods were, however, banned except those which had to satisfy the criteria of 'essentiality' like edible oils, kerosene, and life-savings drugs and could only be imported by the designated government monopoly import trading agencies. The licensing system was supplemented by a tariff structure, which was to provide additional protection to domestic industries from foreign competition.

In June 1966, India devalued the rupee from Rs. 4.76 to Rs. 7.5 per dollar agreed with the World Bank and IMF package and this was followed by another severe drought. The nominal devaluation was 36.5 percent in terms of exchange rate dollars per rupee and the devaluation was 57.6 percent when exchange rate is measured rupees per dollar. This was accompanied by some liberalisation of import licensing and cuts in import tariffs and elimination of export subsidies for approximately a year. But by 1968, intense domestic

reaction in the wake of devaluation led India to turn its policy stance towards inward looking with vengeance. So far as liberalising initiatives were concerned, they were almost all reserved and import controls tightened. This regime was consolidated and strengthened in the subsequent years to come and remained more or less intact till the beginning of a period of phased liberalisation in the late 1970s.

Beginning in the export-import policy of 1977, the attitude to import controls changed. The reforms of export-import policy undertaken successively, which started by about the late 1970s. From 1977 onward, there has been a slow but sustained relaxation of the import control system, particularly in the direction of expanding the scope of the OGL list. Pursell (1992) quoted two factors facilitated the emergence of the liberalisation phase. First, by mid-70s, industrialists themselves were beginning to find the strict regime counterproductive and at the same time a domestic lobby in favour of liberalisation of imports of raw materials and machinery had come to exist and there was no counter lobby in the case of raw materials and machinery imports that had no import substitutes. Second, improved export performance and remittances from overseas workers had led to the accumulation of a comfortable level of foreign exchange reserves. These reserves lent confidence to policy makers.

Towards, the end of the 1970s, India's failure to significantly step up the volume and proportion of her manufactured exports in the face of the Second oil Price Shock began to worry the policy makers. It led to the policy concerning realisation that international competitiveness of Indian goods had suffered from growing technological obsolescence and inferior product quality, limited range and high cost which in turn were due to the highly protected local market. Another limiting feature for Indian manufactured exports lay in the fact that marketing channels in the industrialised countries were substantially dominated by MNEs. The government intended to deal with the situation by introducing a degree of flexibility in the trade policies. The policy was accompanied by putting emphasis on the modernisation of industry with liberalised imports of capital goods and technology, exposing the Indian industry to foreign competition by gradually liberalising the trade regime, and assigning a greater role to MNEs in the promotion of manufactured exports. This strategy was reflected in the policy pronouncements of the 1980s. These covered the emerged areas: liberalisation of industrial licensing (approvals) rules and exemption from foreign equity restrictions under FERA to 100 percent export-oriented units. The trade policies play a role to shape gradually liberalised the

imports of raw materials and capital goods by gradually expanding the list of items on the OGL.

Several capital goods, which until 1976 remained under stringent import licensing, were steadily liberalised as were shifted to the OGL category. There has been somewhat greater permissiveness in the administration of import licensing as a steady liberalisation of imports of capital equipment and of technology started soon after by about 1976. The number of capital goods items on the OGL list expanded from 79 in 1976 to 1,329 in April 1990. The basic intension of these changes was to allow domestic industries to modernise, and the OGL status was usually accompanied by reduction in custom tariff rates. According to Prusell (1992), the import licensing of capital goods in the restricted list was administered with less stringency during the 1980s. To explain its consequences, Goldar and Renganathan (1990) showered that the import penetration ratio in the capital goods sector increased from 11 percent in 1976 to 18 percent in 1985. World Bank (1989) and Aksoy (1992) mentioned that the goods in several instances that were allowed to be imported were imperfect substitutes of domestically produced goods and thus import liberalisation during this period may not have impacted to immediate direct competition to established producers of intermediate and capital goods. Furthermore, there had been an increase in the average effective tariff rate on capital goods from 37 percent in 1973 to 63 percent in 1988. Also, the imports of finished consumer goods remained in the banned list for the entire duration of the 1970s and 1980s.

CONCLUSIONS

he evolution of the policy formulation and the implementation over the years has often been described as 'gradual' (or denigrated or stuck) in terms of pace and 'broken' (or ineffective) in terms of achieving the outcomes that policy makers ostensibly intended. There has been a major consensus in intellectual climate of economic thinking to identify the Indian economic era. Three broad periods are identified in terms of pace and scope of the evolution of economic policies in the post-independence period of India. The first phase – since independence to the mid 1980s- was one of state controlled (or in commanding height or state conservatism or interventionist), which was described as inward looking posture (or of reforms by stealth) [Bhagwati and Srinivasan, 1984], and was also christened as disgusted funereal pace of liberalisation [Joshi and Little, 1994]. The second phase - from the mid 1980s to the early

1990s or prior to 1991- was a period of gradual, hesitant and uneven economic reforms as was described reforms were lacking in boldness and were lopsided, as was coinage slow shifting from planning the economy to management of the economy [Kurien, 1996] and which was an effort at more fundamental change at freeing the economy and was termed as piecemeal measures i.e., some minimal management by the state with the liberalised measures occurring mostly in the trade and industrial sector[Bhagwati, 1993]. The third phase from June 1991 to the present is IMF-World Bank led stabilisation cum structural adjustment package of reforms which aimed at to introduce full blown economic liberalisation of outward oriented rapid, speedy and radical economic reforms, with the reforms encompassing almost every aspect of the policy regime in development strategy [Byres, 1999].

Short-run disequilibrium dynamics and long-run equilibrium relations of output, prices, investment, the sustainability of public deficits, current account deficits at both level and rate values of macroeconomic instability analysis brings into sharp focus of the role of fiscal, monetary, BOP and exchange rate policies. It involves the following interdependent analytical issues such as their modus operandi, coordination between the policies, channels of causation, and degree of effectiveness to influence effective demand. The policy dynamics of this chapter provide useful guidance for development policy in India, particularly relating to macroeconomic growth process. In particular, they have a number of implications for identifying macroeconomic instability sub-periods. Several of the policy changes discussed in this chapter has significant implications for the Indian macroeconomic behaviour and on the relationship between macroeconomic policies and growth. The complexity of the Indian policy regime and the occasional shifts in economic policy provides a guideline for this research in delineating the links between policy variables and the behaviour of saving, investment, and output growth in the Indian context, as is the task for the chapters to follow. In the next chapters, it would report the following sets of policy exercises corresponding to: fiscal policy, monetary policy, exchange rate or currency devaluation policy, and policy mix. All comparisons are made empirically with the sample validation solutions.

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