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# SOME REVIEWS ON ECONOMIC REFORMS IN INDIA

**Poonam Chauhan*[1]**

[1]Research Scholar, Home Science, C.M.J. University, Shilong, Meghalaya, India.

## ABSTRACT

After Independence, the managers of the Indian economy found that the world has been sharply divided into two blocks: the one led by the capitalist economies and other led by the communist economies, primarily the then USSR. There was a cold war between these two blocs. Less developed economies had no option than to join either of the two and invite the ire of the opposite bloc. Especially those economies that were under the British Empire and won freedom during 1940's faced a difficult choice. India chose to keep a safe distance from both the blocks by inventing the idea of a mixed economy. In doing so, India invited as much favor as suspicion from both the blocks. Some economists hold the opinion that the Indian economy was pro-capitalism in its core that wore the façade of a socialistic economy. The state-managed economic endeavors facilitated capital formation in the private sector, often at the cost of the public sector and resources, preparing for a smooth transition to open capitalism in future when the conditions were ripe for such a transition.

## INTRODUCTION

Bardhan (1984) has given a vivid picture of this possibility. Nevertheless, the officially proclaimed management policy of the national economy of India was modeled on the socialistic pattern, primarily that of the USSR. It is relevant to note that since the 1970's, the growth rate of the USSR economy had slowed down substantially. Extensive economic development, based on vast inputs of materials and labor, was no longer possible; yet the productivity of Soviet assets remained low compared with other major industrialized countries. Product quality needed improvement. Soviet leaders faced a fundamental dilemma: the strong central controls of the increasingly conservative bureaucracy that had traditionally guided economic development had failed to respond to the complex demands of industry of a highly developed, modern economy[1].

Soon after independence, India adopted the path of planned development where the public sector was to play a dominant role in fostering growth at both the central and state levels. The First Five-Year Plan, which was launched in 1950-51, was based on the Harrod-Domar model and primarily concentrated on raising the level of investment in irrigation, power and other infrastructure for accelerating growth. The development strategy was changed radically in 1956 with the initiation of the Nehru-Mahalanobis model of industrial development that emphasized the development of heavy industry under the public sector. Domestic industry was protected from foreign competition through high tariff walls, exchange-rate management, controls and licences. This strategy of import substitution and heavy-industry promotion has been criticized

for having created a non-competitive, inefficient, capital-intensive and high-cost industrial structure. It is further argued that this policy discriminated against labour-intensive tradable agriculture and resulted in unwarranted export pessimism because of excessive concern about self-sufficiency. The criticism, however, must be balanced against the fact that during this period India built a large infrastructure not only in heavy and machine goods industries, but also in the areas of power, irrigation, credit, higher education, scientific research and training[2].

The Indian economy imports about 70% of its oil requirements from international markets. This makes the economy vulnerable to any increases in oil prices in the international markets. However, the oil prices do not affect the economy homogenously. The services sector is far less dependent on oil than the industrial sector. In fact, as most of the growth in the economy is coming from the services sector, the economy and its performance is becoming less vulnerable to oil price fluctuations. Another reason for the oil-price shocks not being fully effective in India is the governments administered pricing policies of oil that diffused the hikes by raising subsidy etc. The obvious shock periods are 1973 to 1974 and 1980, the two shocks that sent the world into a recession. However, 1990 (the first Iraq war) and the period around 1999 also show significant oil price hikes. The industrial growth rates are also plotted for the same year in figure 5A (units on the right hand margin). We find that the industrial growth was low during the first hike during 1973-1974 but the second hike in 1980 does not seem to have any effect. The hike in 1990 coincides with a fall in industrial growth rates but the hikes during 1999 - 2000 again do not seem to have any impact on industrial growth. From all of this, it seems that an oil price hike has very limited impact on the industrial growth rates as well.

**THE ECONOMIC SITUATION IN 1990-91**

The Indian economy had to face many uncertainties in 1990-91. The effects of the political situation at home, and the persistent fiscal imbalances were accentuated by the Gulf crisis which intensified strains on an already weak balance of payments position. It is a measure of the inherent strength of our economy that it withstood the effects of these shocks rather well. It is also a measure of solid gains registered by our economy during the last forty years since independence. Agricultural output and industrial production continued to grow though their sustainability came under serious doubt. It is estimated that the growth of Gross Domestic Product (GDP) in real terms during 1990-91 will be about 5 per cent. However, due to the combined impact of internal and external factors, consumers have been faced with double digit inflation and the economy is faced with a serious balance of payments crisis. On the domestic front, particular significance is attached to medium-term large and persistent fiscal imbalances which have strained the balance of payments situation and accentuated inflationary pressures in the economy. These factors have been sharply exacerbated by the third oil shock and the related dislocations caused by the crisis and the war in the Gulf during 1990-91.

Until recently, while many critics focused their attention on these limitations, the general thrust of agricultural policy within the framework of planning had not been seriously questioned.

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However, after the new economic policy was introduced in 1991, all aspects of planning and associated macroeconomic policy have come under serious discussion:

- The inward-looking, import substitution development strategy, which was aimed at rapid industrialization, shifted resources from tradable agriculture to industry by turning the terms of trade against agriculture.

- The overvaluation of the exchange rate subsidized imports and adversely affected all exports, especially agricultural exports.

- Most sector-specific policies at all stages of production, consumption and marketing of agricultural produce, worked against agriculture. For example, the price policy was in practice designed primarily to help the consumers. Farmers were generally given low administered prices in the name of helping the urban poor even when they had to pay higher prices for domestically produced inputs because of the protection given to local industry. In addition, a major proportion of the costs of the inefficient functioning of parastatal organizations, such as the Food Corporation of India, were borne by farmers.

While public opinion in India continues to move toward the view that liberalization has been good, that more of it is needed, and that its pace must be accelerated, the view in some scholarly and policy circles has turned skeptical. It is being pointed out that the average annual growth rate of gross domestic product (GDP) hit the 5.6 percent mark in the 1980s, well before the launch of the July 1991 reforms. Alternatively, the growth rate in the 1990s was not much higher. Therefore, liberalization cannot be credited with having made a significant difference to growth in India. Yet the aggregate growth data tells us that the acceleration of economic growth began earlier, in the early or mid-1980s, long before the exchange crisis of 1991 and the shift of the government of Narasimha Rao and Manmohan Singh toward neoliberal economic reforms." DeLong continues: "Thus apparently the policy changes in the mid- and late-1980s under the last governments of the Nehru dynasty were sufficient to start the acceleration of growth, small as those policy reforms appear in retrospect. Would they have just produced a short-lived flash in the pan—a decade or so of fast growth followed by a slowdown— in the absence of the further reforms of the 1990s? My hunch is that the answer is 'yes.' In the absence of the second wave of reforms in the 1990s it is unlikely that the rapid growth of the second half of the 1980s could be sustained. But hard evidence to support such a strong counterfactual judgment is lacking."

During this period it was observed that the average annual growth rate during the eleven-year period from 1992–93 to 2002–03. One obvious criterion for defining the pre-1991 reform period or the "1980s" is to select 11 years immediately preceding the post-1991 reform period: 1981–82 to 1991–92. Average annual growth rate during this period is 5.3 percent. If the inclusion of the crisis year, 1991– 92, into this period is objectionable, we can consider the ten-year period between 1981–82 and 1990–91. In this case, the average growth rate rises to 5.7 percent. Either way, growth rates between the 1980s and 1990s are comparable. But consider for a moment annual average growth rates until 1987–88. Indeed, even limiting ourselves to 1981–82 to 1987–

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88, we get an average growth rate of only 4.8 percent, which is strictly below the growth rate of 4.9 percent achieved during the Fifth Five Year Plan (1974–79). Thus, had it not been for the unusually high growth rate of 7.6 percent during 1988–91, we would not have reason to debate whether the reforms of 1990s made a significant contribution to growth. The implication is that any explanation of growth in the 1980s must explain the exceptionally high growth during 1988–91[3].

## THE MAIN COMPONENTS OF NEW ECONOMIC POLICY

The aim of the new policy was to bring about a realignment of domestic demand with available resources and to initiate changes in supply and production structures with a view to eliminating the external imbalance. The economy was to be liberalized and gradually integrated with the world economy by the dismantling of tariff walls, the protection of foreign direct investment and upgrading the technology of production in various fields. The broad thrusts of the programmes were financial stability, outward-looking policies and deregulation of domestic markets.

The reforms consisted of two components. The short-term immediate stabilization measures focused on correcting the disequilibrium in the foreign exchange market through demand reduction, reforms in trade policy, a reduction in the fiscal deficit and the dismantling of barriers to the free flow of capital. External competitiveness was to be improved through a large nominal depreciation of the exchange rate.

The medium-term structural adjustment programme introduced reforms in fiscal, exchange rate, trade and industrial policy as well as policies concerning the public sector, the financial sector and the capital market. These reforms included elements such as deregulation of prices and investments, changes in the structure of taxation and public expenditure, moderation in wage increases, privatization of public enterprises and greater integration with the world economy.

The adjustment policies introduced were not specific to the agricultural sector, but concerned the entire economy. Nevertheless, keeping in view the importance and predominance of the agricultural sector in the Indian economy, in terms of both income generation and employment and its intimate relationship with other sectors of the economy through input-output and consumption linkages, the macroeconomic and other changes implied in the stabilization and structural adjustment programme had a significant impact on the sector.

Bhagwati and Srinivasan (1975) offer a fascinating political economy analysis of the 1966 devaluation. In a key concluding paragraph on page 153, they note, “The political lesson seems particularly pointed with regard to the use of aid as a means of influencing recipient policy, even if, in some objective sense, the pressure is in the ‘right’ direction. The Indian experience is also instructive for the political timing of devaluation: foreign pressure to change policies, if brought to bear when a government is weak can be fatal.” This is an important lesson in the political economy of reforms. 1957–58 to the even lower level of 3 percent in 1975–76. Since consumer goods imports had been essentially banned, the incidence of this decline was principally borne

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by machinery, raw material and components. The impact on the pattern of industrialization and efficiency was visible. Pursell (1992, pp. 433–4) offers a vivid description of the costs to the economy in the following words: "During this period, import-substitution policies were followed with little or no regard to costs. They resulted in an extremely diverse industrial structure and high degree of self-sufficiency, but many industries had high production costs. In addition, there was a general problem of poor quality and technological backwardness, which beset even low-cost sectors with comparative advantage such as the textiles, garment, leather goods, many light industries, and primary industries such as cotton." Pursell (1992, p. 434) continues, "Although import substitution reduced imports of substitute products, this was replaced by increased demand for imported capital equipment and technology and for raw materials not domestically produced or in insufficient quantities. During the 1960s and the first half of the 1970s, the former demand was suppressed by extensive import substitution in the capital goods industries and attempts to indigenize R&D. By about 1976, however, the resulting obsolescence of the capital stock and technology of many industries was becoming apparent, and a steady liberalization of imports of capital equipment and of technology started soon after." wo factors facilitated the emergence of the liberalization phase. First, as already hinted in the above quote from Pursell (1992), by the mid-1970s, industrialists themselves were beginning to find the strict regime counterproductive and started pressing the government for the relaxation of controls. A domestic lobby in favor of liberalization of imports of raw materials and machinery had come to exist. At the same time, in the case of raw materials and machinery imports that had no import substitutes, there was no counter lobby. Second, improved export performance and remittances from overseas workers in the Middle East had led to the accumulation of a comfortable level of foreign-exchange reserves[4].

## IMPACT OF THE REFORMS

The impact of reforms could be seen most clearly on trade flows. Pursell states,this succinctly and emphatically, "The available data on imports and import licensing are incomplete, out of date, and often inconsistent. Nevertheless, whichever way they are manipulated, they confirm very substantial and steady import liberalization that occurred after 1977–78 and during 1980s." He goes on to note that 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. The share of non-POL imports in the remaining imports increased from 8 percent to 37 percent over the same period. Quite apart from this compositional change, there was considerable expansion of the level of imports during the 1970s and the second half of the 1980s. Increased growth in exports due to the steady depreciation of the real exchange rate and remittances from the overseas workers in the Middle East had begun to relax the balance of payments constraint during the first half of the 1970s, leading to the expansion of non-oil imports at the annual rate of 17.8 percent. This rapid expansion continued during the second half of the 1970s with non-oil imports registering an impressive 15 percent annual growth rate over the ten-year period spanning 1970–79. In contrast, in the subsequent five years when the real exchange rate

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appreciated slightly and the income growth slowed down, non-oil imports expanded only 7.1 percent per annum. Again, during 1985–90, they grew by 12.3 percent. Thus, liberalized licensing rules flexibly accommodated the increased demand for imports during the fast-growth periods.

Joshi and Little find increased demand through fiscal expansion, more efficient use of the existing resources (due to liberalization), and the rise in the real yield of investment in private manufacturing as the principal sources of the shift in the growth rate. Neither Joshi and Little nor Chand and Sen separately analyze the period 1988–91, which is crucial to obtaining comparable growth rates between 1980s and 1990s. Prima facie it would seem that the results of Chand and Sen would hold even more strongly for this period. The reason is that average annual industrial growth of 9.2 percent during 1988–91 was significantly higher than 6.2 percent growth achieved during 1984–88. In view of the fact that private investment as a proportion of GDP did not rise, the substantially higher growth in industrial output is likely to be the result of increased productivity[5].

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