WEEKLY CASE STUDY-4

Overview

Over three decades ago, a significant event unfolded in India on July 24, 1991. The then finance minister, Manmohan Singh, presented a special budget that changed the country's direction. Before that, India was growing slowly at 3.5% each year. But after this budget, things started to look up for the country's economy.

The subsequent changes set in motion a series of reforms that reshaped India's economic landscape, ushering in a new era of liberalisation. This case study delves into the pivotal decisions and their far-reaching impact, shedding light on how a single budget presentation altered the trajectory of an entire nation.

Economic Liberalisation in India

Economic liberalisation involves lifting unnecessary restrictions and controls from a country's economy, enabling businesses and enterprises to maximise their contributions. It's crucial to understand that liberalisation doesn't imply an unregulated economy.

In 1991, India made economic changes to boost industries, invite more private and foreign investments, and create a free-market system. Certain industries, once reserved for the government, opened up for private companies.

The economic liberalisation happened because of the crisis India faced in 1985. The country couldn't pay for crucial imports or manage debt. This crisis led the country to the brink of bankruptcy. To address this, Dr Manmohan Singh, the then Finance Minister, introduced economic changes, giving businesses more freedom and paving the way for economic growth..

India Before Liberalisation

The Indian government aimed to promote industrialisation by channelling investments into the production of capital goods and imposing restrictions on imports. Simultaneously, efforts were made to support the rural population, resulting in a modest 1.5% return on capital in the public sector during the 1980s.

However, the private sector faced various limitations, including import restrictions, antitrust laws hindering business growth, inefficient public monopolies, and the complex License Raj for opening new businesses. The country’s GDP per capita grew at an annual rate of only 3.5% in the years before the 1980s. Even in 1985, the GDP per capita was $447. With such growth rates and facing a public debt of $70 billion in 1991, India had to take urgent measures to avert bankruptcy.

Features of Liberalisation in India

The features of liberalisation in India helped remove several restrictions and become private-sector friendly:

- To abolish the License Raj in India. Licence or Permit Raj was a complicated system of regulations and restrictions imposed to establish and operate businesses between 1947 and 1990.
- To reduce interest rates and tariffs.
- To curb the monopoly of the public sector from different areas of the economy.
- To approve foreign direct investment in different sectors.

Objectives of Liberalisation in India

- Encourage competition among local businesses
- Facilitate foreign trade and manage imports and exports
- Enhance technology and attract foreign capital
- Cultivate a global market presence
- Reduce the country's debt burden
- Harness economic potential by welcoming private and multinational investments

- Promote active private sector involvement in development
- Limit the public sector's role in future industrial growth
- Foster competition in the economy to boost efficiency

Reforms Under Liberalisation

- **Industrial Sector Deregulation:**

The deregulation in the industrial sector involves removing hindrances to entry, reducing monopolistic practices, and creating a competitive and market-driven environment. This process is the systematic decrease or removal of government rules and authority on sectors and companies.

- **Financial Sector:**

The purpose of financial sector reforms is to create a streamlined financial system that improves the optimal allocation of resources, maintains trust in the financial system, facilitates financial inclusion and ensures stability.

- **Taxation:**

Tax reform is about modifying tax collection or administration methods. This is generally conducted to improve tax management or to provide social and economic benefits.

- **Trade and Investment Policy:**

In this reform, the compulsion to acquire licences was stopped for all industries. However, certain industries that are related to cigarettes, alcohol, electronics, drugs, pharmaceuticals, industrial explosives, hazardous chemicals and aerospace are not included. The need for licences to establish new units or expand existing ones has been terminated.

- **External Sector:**

This reform encompasses various policy actions and structural adjustments to improve the efficiency, competitiveness, and resilience of the external sector. It involves initiatives such as trade liberalisation, exchange rate management, regulations overseeing foreign investments, and efforts to stimulate exports.

- **Foreign Trade Policy:**

This reform strives to improve the country's integration into global value chains and set India as a major global export hub.

- **Forex:**

Foreign exchange reforms were initiated in 1991 with the devaluation of the Indian rupee against foreign currencies. This meant that a US dollar or British pound could buy more rupees than before, indicating that these foreign currencies could purchase more goods in the Indian market.

Impacts of Liberalisation in India

Economic liberalisation impacted the country in both positive and negative ways as follows.

Positive Outcomes

- **Investment diversification:**

Post the liberalisation, investors got the liberty to allocate a part of their investment portfolio to a diversified range of asset classes. Thereby creating additional income.

- **Free flow of capital:**

Liberalisation has facilitated the unrestricted flow of capital in our country, providing companies easy access to funding from investors. In the pre-liberalisation era, venturing into lucrative projects was discouraged due to a lack of capital. This changed in 1991, ushering in higher growth rates.

- **Change in the agricultural sector:**

After 1991, there was a considerable change in cropping patterns in India. However, the impact of liberalisation on the agricultural sector cannot be determined accurately.

- **Quantitative Easing**

This essentially involved the Federal Reserve Bank reducing the interest rate from 5.25% to nearly 0 over the next few months in order to increase the flow of credit into the economy.

- **Regulations**

In 2010, Barack Obama signed the Dod-Frank Act, which put greater regulatory powers in the hands of the government to control financial institutions that were on the brink of failing. It also made some attempts to control predatory lending by financial institutions.

There were other federal legislation, such as the 2009 American Recovery and Reinvestment Act (ARRA), to create and preserve jobs as well as provide unemployment insurance and other safety net programs, such as food stamps.

Negative Outcomes

- **Economic destabilisation:**

Such a significant economic reform resulted in a reshuffling of political and economic power, causing considerable destabilisation in the Indian economy.

- **Competition from MNCs:**

Due to the liberalisation of several restrictions, the country saw an increase in the number of MNCs in India, threatening the existence of several small companies.

- **Foreign Direct Investment (FDI) in the banking sector:**

Removing constraints on Foreign Direct Investment in the banking and insurance sectors resulted in a decrease in the government's ownership in both these industries.

- **Rise in mergers and acquisitions**:

The expanded opportunities for mergers and acquisitions in the post-liberalisation era have endangered the job security of employees in smaller firms. When merging with larger companies, employees from smaller firms often face the challenge of extensive re-skilling, causing a slowdown in productivity.