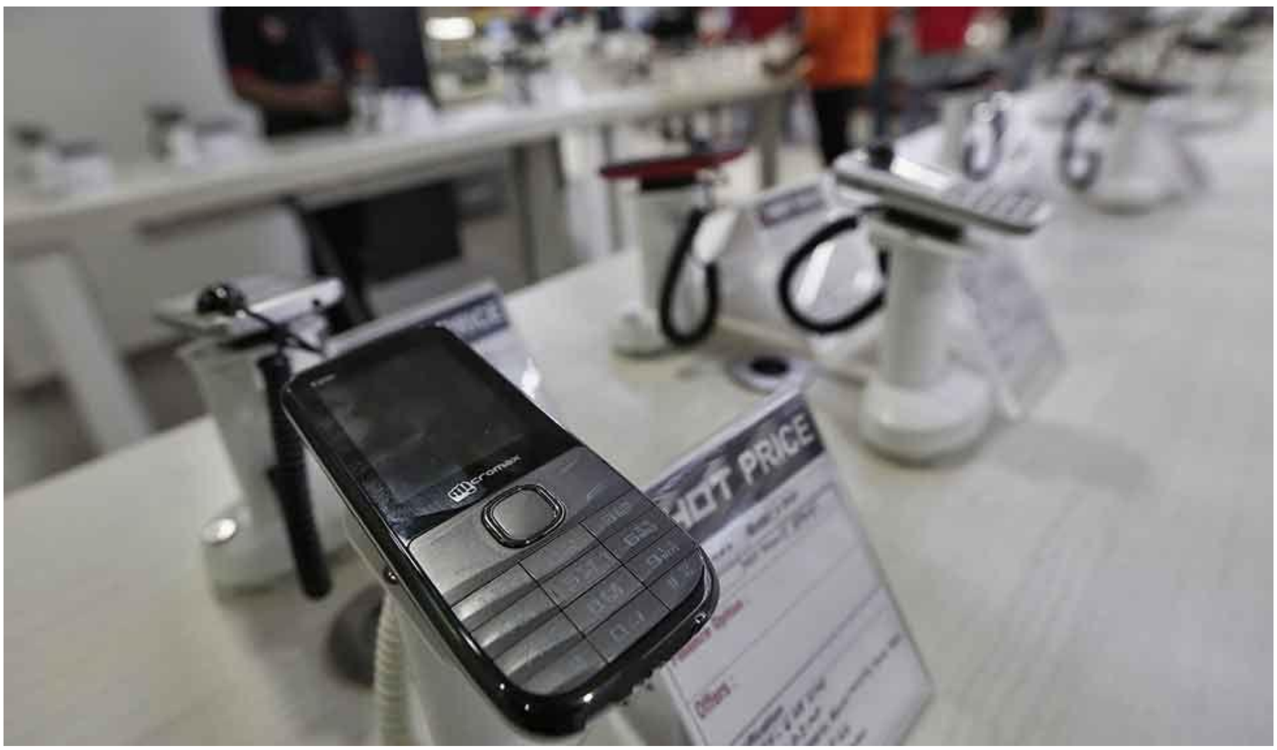
GUEST COLUMN

The path of reforms

By C. Rangarajan | February 21, 2016



THE INDIAN economy has travelled through an exciting period in the last two and a half decades. In the post-independence economic history of our country, 1991 stands out as a watershed year. This was the year in which the economy faced a severe balance of payments crisis. In response, we launched a broad-ranging economic programme, not just to restore the balance of payments, but to reform, restructure and modernise the economy.

Economic reforms: break with the past

The break with the past came in three important directions. The first was to dismantle the complex regime of licences, permits and controls that dictated almost every facet of production and distribution—what to produce, where to produce, how to produce and how much to produce. The entrepreneur has now greater freedom to decide on all these choices. The second change in direction was to reverse the strong bias towards state ownership of means of production and proliferation of public sector enterprises in almost every sphere of economic activity. Areas once reserved exclusively for the state have been thrown open to private enterprise. The third change in direction was to abandon our inward looking trade policy. By embracing international trade, India signalled that it was boldly abandoning its export pessimism and was accepting the challenge and opportunity of integrating into the world economy to leverage the well and long known gains arising from the welfare and efficiency benefits of free trade.

The emphasis on efficiency does not mean ignoring concerns relating to equity. As the role of the government as a producer of marketable goods and services shrinks, its role as a producer of public goods and services increases. That is why it has been remarked somewhat paradoxically that more market does not mean less government, but different government.

Performance since liberalisation

That the road we chose to travel in 1991 was appropriate is indicated by the performance of the Indian economy since 1992. In the post-reform period which started in 1992-93, the economy has grown at an average rate of 6.8 per cent. In the more recent period, the growth rate has been even higher. Over the decade beginning in 2004-05, the average annual growth rate has been 7.6 per cent. Between 2005-06 and 2010-11, the growth rate was 8.7 per cent. Contrast this with the annual growth rate of 3.5 per cent between 1952 and 1980. It is true that the Indian economy grew between 1980 and 1990 at 5.6 per cent. But the economy faced its worst crisis in 1991-92 and the growth rate fell to 1 per cent. It is extremely doubtful that without a change in the strategy of development, growth would have picked up again.

Reforms in the Reserve Bank of India

In the first phase, reforms were introduced in the industrial sector, external trade and investment sectors, exchange rate management, fiscal policy and financial sector. Later, communications and other key infrastructure sectors were covered. I am happy to have been part of the team that initiated the reforms.

While I took part in designing the overall architecture of reforms, I had a special responsibility with respect to the Reserve Bank and the financial system. Let me highlight a few initial changes.

First, the institutional framework relating to monetary policy underwent a big change. The phasing out of the system of the issue of ad hoc treasury bills put an end to the monetisation of fiscal deficit. To that extent, the fiscal dominance over monetary policy became abridged. The other important change in the institutional framework was compelling the government to go to the market and borrow at market determined rates. This had two important implications. First, the bank rate and later the repo rate emerged as an important tool of monetary policy. Besides, open market operations also emerged as a powerful tool of monetary policy. When the government borrowed at less than market rates, this instrument could never be used. Thus, the RBI has emerged as a stronger institution with enhanced functional autonomy.

The second important change was in relation to the banking system. The banking sector reforms that were introduced included the introduction of prudential norms, capital adequacy requirements and income recognition criteria. The amendment to the Nationalisation Act enabled the government to reduce the government holding to 51 per cent. Private sector banks were given licences for the first time after several decades. The Board for Financial Supervision was set up to oversee and supervise the banking system as well as the non-banks in a coherent and coordinated manner.

Third, the exchange rate regime underwent a radical change. After the devaluation of rupee, the EXIM Script Scheme was introduced to make exports attractive. This was followed by a dual exchange rate system. Finally, in early 1993, the market determined exchange rate system was introduced. This, in many ways, was a revolutionary change. The new regime has stood us in good stead.

With the deregulation of administered interest rate structure, financial markets became more vibrant. The government security market for the first time started gaining depth. With the change in the exchange rate system, the foreign exchange market also became active.

Reforms and growth

Reforms have to remain as part of a continuing agenda. The basic principle of the liberalisation of creating competitive markets with minimal barriers to entry should be extended to all sectors. Reforms do not necessarily translate into growth. The investment sentiment must be carefully nurtured. For reforms to be credible, it must not only result in higher growth but also benefit all sections of society. In that sense, reforms are not ends in themselves. At the same time, equity will remain a dream, if it is not supported by growth spurred by reforms.

The author was governor, Reserve Bank of India, and chairman of the prime minister's economic advisory council.