Economic Reforms Since 1991: Evidence from India

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Abstract:
Indian economy has seen various ups and downs since its inception on world map. However, Pre-Mughal era, Mughal era, Colonial era, Post-Independence era and Post-Economic Reform era are some of the major sections in which the economic history of India can be divided. The present study focuses mainly on the Post-Economic Reform period or neoliberal era. It tries to elaborate the major reforms which were introduced in Indian economy since 1991. The study finds that although reforms were introduced in almost all the sectors of the economy after 1991, major reforms were introduced in the external sector of Indian economy. Within the external sector; exports, foreign direct investments and external debt were the main players which experienced drastic policy reformulation and implementations.

Keywords: Economic Reforms, External Sector, International Trade, Foreign Direct Investment, External Debt.

1 Introduction:

From 1991 onwards India has witnessed wide ranging reforms in various sectors of the economy. The economic reforms were introduced due to several internal and external imbalances which India experienced during late 1980’s and early 1990’s. However, the most important immediate factors which triggered the economic crisis in 1991 were the Gulf war and the collapse of the Soviet Union. The Gulf war led to the surge in India's oil import bill and cessation of exports to Iraq due to UN trade embargo on that country. The collapse of Soviet Union, India's major trading partner at that time further aggravated the economic crisis and undermined India's faith in central planning. To deal with this crisis, India initiated an emergency programme of economic stabilization aimed at correcting the weaknesses that had developed on the fiscal and balance of payments fronts over the past decades. Simultaneously, it also embarked on a programme of structural reform to remove the rigidities that had entered into the various segments of the economy. In this process, India introduced several fundamental changes in fiscal policy, the monetary and financial system, industrial policy, the external trade and payment system. However, significant reorganisation of external sector remains the highlight of the economic reforms programme of 1991.
2. Review of Literature:

Singh (1964) long back had expressed extreme discontent towards the performance of the external sector and condemned import substitution policy followed by India. The policy of import substitution turned out to be biased against promotion of exports and restricted India’s entry in the global market. He suggested variety of reforms in the export sector but unfortunately its implementation came much later after India experienced historic economic crisis in 1991. According to Jalan (1991) the year 1990-1991 was the cruellest year in Indian history and the export performance of Indian economy since independence was despondent when compared with other developing countries. Ahluwalia (1994) while rejecting the arguments of the critics of economic reforms considered India’s efforts of liberalising its economy since 1991 as an ‘economic revolution’. He however, suggested a cautious approach towards opening up of route to foreign capital since it brings in the elements of volatility. Prasad (1997) examined the impact of economic reforms on exports of India and came to the conclusion that during 1990-1991 to 1994-1995, India experienced a high growth compared to growth rates of world exports. The study also revealed that the growth in the values of exports from India was mainly due to growth in quantity of exports and not due to real increase in unit values. This showed that Indian exports were becoming more competitive in terms of prices.

Ramaseswamy (1999) discussed issue of India’s external sector and attributed its neglect to the limited international linkages of industrial firms and production. Accordingly, a significant way of gaining entry into global market was through incorporation of Indian firms into international networks of trade and production. Nayyer (2000) studied the impact of external sector reforms in India on capital account liberalisation. Mexican Crisis of 1994 was considered by the author as an important reason for discouraging India for moving ahead with capital account liberalisation in post reform period. Panagriya (2001) commended the impact of economic reforms on India’s external sector but called for further reforms particularly in trade sector. Virmani (2001) viewed external sector reforms in India since 1991 as the most successful reforms. It had disclaimed the fear of ballooning of imports in post reform period, while the performance of current account and capital account had improved significantly. Basu and Maertens (2007) hailed the surge in exports particularly of Software and IT and, felt that in order to fully analyse the benefits of an open economy India should try to overcome some of the constraints like: infrastructure, rampant corruption, labour and bankruptcy regulation.

3. Economic Reforms: Concept and Strategy:

The term ‘economic reforms’ is probably one of the most widely used and popular term in the field of economics today. It means an inclination towards neoliberal policies. Faced with the structural weaknesses on the domestic front and severe external shock, a large number of developing countries have implemented economic reform during the past several decades especially since the decade of the 1980’s with a view to ensure a better allocation of resources and thereby, improve economic performance through changes in economic policies (Sharan and Mukherjee, 2001). The process of economic reform has included macroeconomic stabilization and structural adjustment.

As is well known India experienced a crisis of unprecedented severity in the early 1990s. The budget deficit had increased from 0.9% of GDP (Gross Domestic Product) in 1980-81 to 2.1% of GDP in 1990-91. The revenue deficit during the same period had gone up from 0.2 percent of GDP to 3.5 percent. The gross fiscal deficit had reached the level of 8.4 percent of GDP in 1990-91 from 7.5 percent in 1984-85. The balance of payments position was on the brink of disaster as in late June 1991, the level of foreign exchange reserves had dropped to levels which
were not sufficient to finance imports of even ten days. Defaults in terms of financing imports and meeting debt service payments looked imminent.

To deal with this crisis, India initiated an emergency programme of economic stabilization aimed at correcting the weaknesses that had developed on the fiscal and balance of payments fronts over the past decades. Simultaneously, it also embarked on a programme of structural reform to remove the rigidities that had entered into the various segments of the economy. In this process, India introduced several fundamental changes in fiscal policy, the industrial policy, the external sector etc (Table 1.1). We discuss below them in a sequential way.
The process of macroeconomic adjustment or economic reform is explained in Table 1.1

Table 1.1

<table>
<thead>
<tr>
<th>Internal and External Imbalances</th>
<th>Economic Crisis</th>
<th>Macroeconomic Adjustment or Economic Reforms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stabilization Programme (Short term strategy)</td>
<td>Followed by</td>
<td>Structural Adjustment Programme (SAP) (Long term strategy)</td>
</tr>
<tr>
<td>Expenditure Reducing Policies</td>
<td>Expenditure Switching Policies</td>
<td>Increase Exports Reduce Imports</td>
</tr>
<tr>
<td>Reduces Aggregate Demand</td>
<td>1)External Sector Reforms</td>
<td>2)Financial Sector Reforms</td>
</tr>
<tr>
<td>Fiscal Measures</td>
<td>Monetary Measures</td>
<td>3)Liberalization</td>
</tr>
<tr>
<td>1) Taxation</td>
<td>1) Interest Rates</td>
<td>4)Privatization</td>
</tr>
<tr>
<td>2) Government Expenditure</td>
<td>2) Monetary Base</td>
<td>5)Globalization</td>
</tr>
<tr>
<td>3) Associated Borrowings</td>
<td>3) Currency Board</td>
<td>6)Budgetary Reforms, etc.</td>
</tr>
<tr>
<td>4) Reserve Requirements</td>
<td>4) Dollarization</td>
<td></td>
</tr>
</tbody>
</table>
Source: Prepared by author.
3.1 Monetary and Financial Sector Reform:

Reform in the monetary policy was considered essential to ensure macroeconomic stability and set free the process of price discovery with a view to enhancing the allocative efficiency of the financial markets. The constituents of monetary policy reform in India since 1991 have included: introduction of an auction system for the central government’s market borrowings; replacement of treasury bills by ways and means advances (WMA); relativization of the bank rate; deregulation of interest rates and deregulation of credit (Sury, 2011).

Reforms in the monetary policy have also been accompanied by a comprehensive financial sector reform. The main thrust of reforms in this sector has been on the creation of efficient and stable financial institutions and markets. Reforms in the commercial banking sector have been largely based on the reports of the committees set up under the Chairmanship of former RBI Governor, M. Narsimham. The first reports on financial system (1992) focused mainly on enabling and strengthening measures. It recommended:

- Progressive reduction in cash reserve ratio to 3%-5%, and statutory liquidity ratio to 25% over the period of five years.
- Deregulation of Interest rates.
- Electronic banking.
- Regulation of the Banking sector by RBI.
- Widening of base of SEBI as a market regulator.
- Risk management.
- Permission to raise capital from public by profitable bank.
- Capital Market Liberalization.
- Abolition of Branch licensing.
- Special tribunals to be set up for recovery of loans.
- Encouragement to private sector banks, including foreign banks, by liberalizing policies.

The second report on Banking sector reforms placed greater emphasis on structural measures and recommended:

- Further strengthening of banking sector in India with greater autonomy for PSB’s (public sector banks) to make them equivalent to international standards. This will speed up inflows of capital.
- Updating of banking laws.
- Merger of strong banks, which will encourage international trade. But the merger of strong bank with weak bank must be avoided.
- International status should be provided to two / three strong / large Indian banks.
- Small banks should be set up to enhance say, local trade.
- Raising capital adequacy ratio (CAR) for increasing risk absorption capacity. CAR should be raised to 9% in 2000 and 10% in 2002 along with panel provisions.
- Non-Performing Assets (NPAs) should be reduced to 3% in by the end 2002.

Following these recommendations significant reforms in the Banking sector in India have been introduced since 1991. The major policy reforms include- dismantling of administered interest rate, major reduction in SLR
(Statutory Liquidity Ratio) and CRR (Cash Reserve Ratio), abolition of firm specific credit controls, permission to private players including foreign participant in the banking sector and improving the banking supervision, etc.

**Industrial Policy Reform:**

The process of economic reforms introduced in India in 1991 got a big boost when the Government of India announced a new industrial policy in the Indian Parliament on 24th July, 1991. The new policy introduced radical changes to unshackle the Indian industrial economy from the cobwebs of unnecessary bureaucratic controls and make market internationally competitive in terms of price and quality. In pursuit of these objectives the government announced a series of initiatives in respect of the policies relating to the following areas:

a) **Delicensing:** Prior to reforms, under the Industrial Act of 1951, all the key industries in India had to acquire license for establishing new units, relocate industries, capacity expansion, to introduce any new commodity in market etc. This process heavily restricted industrial development. In post reform scenario, a radical change was made.

Exemption from licensing was granted not only to the new investment projects but also to the existing units for expansion and manufacturing of new items. True to the commitment in the policy that “Government’s policy will be continuity with change”, subsequent delicensing has left only five sectors subject to compulsory licensing. These were:

- Arms and ammunition, explosives and allied items of defence equipment, defence aircraft and warships.
- Atomic substances.
- Narcotics and psychotropic substances and hazardous chemicals.
- Distillation and brewing of alcoholic drinks.
- Cigarettes/cigars and manufactured tobacco and substitutes (Panagariya, 2004).

b) **Dereservation:** Under the Industrial Policy Resolution 1956, the number of industries reserved for the public sector was 17. The 1991 industrial policy reduced this number to 8. As a result of further reviews, only atomic energy and railway transport remained reserved for the state.

c) **Disinvestment:** Another important step taken to reform Indian industrial sector has been the ‘disinvestment’ programme. It implies privatization or transfer of public assets to private sector. In 1993 committee under the chairmanship of Dr. C. Rangarajan was set up to look into the disinvestment of public sector units (PSU’s). The committee recommended that except for atomic energy and defence where government should have majority holdings in equity, PSU’s can be disinvested upto any limit. Full fledge disinvestment commission was constituted in 1996. Following is list of few PSU’s where partial or full disinvestment has been implemented:

- Oil and Natural Gas Corporation (ONGC).
- Gas Authority of India Limited (GAIL).
- Mahanagar Telephone Nigam Limited (MTNL).
- Power Grid Corporations.
- Indian Airlines.
- Indian Petrochemicals Corporation Limited (IPCL).
- Hindustan Zinc Limited.
- Modern Food Industries (India) Limited.
National Fertilizers Limited (NFL).
LNG Petro Net.
Videsh Sanchar Nigam Ltd. (VSNL), etc.

d) Amendment in MRTCP Act:- Under this Act firms with assets above a certain size (Rs.100 crore since 1985) were classified as MRTP firms. Such firms were permitted to enter selected industries only on a case by case approval basis. This had a deleterious effect on many large firms in their plans for growth and diversification. The law regulating monopolies has been amended to remove the threshold limit of Rs. 1 billion on the assets of large business houses and to eliminate the need for prior approval from the government for capacity expansion, capacity creation, amalgamation, mergers or takeovers on the part of sick companies (Nayyer, 1996). The amended Act gives more emphasis on prevention and control of monopolistic, restrictive and unfair trade practices so that consumers are adequately protected from such practices.

3.3 External Sector Reforms:

Reforms in the external sector have been more extensive and touched upon every aspect of the balance of payment problem. To begin with, the exchange rate policy regime was changed from a fixed exchange rate system to market determined one.

1) Convertibility of Current and Capital account: - Following the BoP (Balance of Payment) crisis in 1991, the rupee was adjusted downward in two stages on July 1 and July 3, 1991 by around 18-19 percent against a basket of five currencies namely the U.S dollar, the Deutschmark, the British pound, the French franc and the Japanese yen. The downward adjustment of the rupee was followed by the introduction of the Liberalization Exchange Rate Management System (LERMS) in March 1992 under which a dual (official and market determined) exchange rate system was adopted. Forty percent of foreign exchange receipts from exports of goods and services were to be surrendered at the official exchange rate while the remaining 60 percent could be converted at the market exchange rates. But as this system was criticized for an implicit tax on exports resulting from the differentials in the rates of surrenders of exports proceeds, it was replaced by a unified market determined exchange rate system in March 1993. Since then the rupee has been kept on float and its value is determined by the forces of demand and supply in the foreign exchange market. The Reserve Bank of India (RBI), however, reserves the right to intervene in the market to enable orderly conduct (Rangarajan 1997). The rupee was made fully convertible on trade account in the union budget 1993-94. On August 1994, the rupee was made fully convertible on all current account transactions. This means importers and exporters can acquire foreign currency at the market determined rate as opposed to the unfavourable government determined rate that was prevalent in the pre-reform era.

While convertibility on trade account has been accomplished, the movement on the capital account convertibility has been rather slow and cautious. After making rupee convertible on current account transactions in August 1994, the Reserve Bank of India appointed in 1997, a Committee under the Chairmanship Shri S.S. Tarapore, the former Deputy Governor of RBI to build a platform for Capital Account Convertibility in India. The committee viewed that upshots in different economies differ and cannot be generalized or applied unanimously. The end product differs from economies to economies depending upon their macroeconomic performance prior to introduction of capital account liberalization and how far they have been successful in establishing their pre-
conditions and timing and sequencing of measures of liberalization of capital account.

For India the recommended among others that capital account convertibility is possible only after the pre-conditions/signposts laid down by it are met with and it should be sequenced over a period of three years beginning with 1997-98.

Among the pre-conditions/signposts, it laid emphasis on:

(i) Fiscal consolidation.
(ii) A mandated inflation target, and
(iii) Strengthening of the financial sector.

**Fiscal Consolidation:** The committee proposed a potent macroeconomic set up and sustainable fiscal deficit as a vital and key pre-condition for capital account convertibility in India. It recommended that gross fiscal deficit as percentage of gross domestic product be reduced from budgeted 4.5 percent in 1997-98 to 4.0 percent in 1998-99 and further to 3.5 percent in 1999-2000.

**Mandated Inflation Rate:** The Committee viewed that inflation should be in single digit in order to instigate capital account convertibility and empowering RBI will be of utmost interest on inflation mandate. The committee advised that there should be 3%-5% mandated rate of inflation for the three-year period from 1997-98 to 1999-2000.

**Strengthening of the Financial Sector:** For strengthening the financial system the committee suggested that:

- Interest rates to be fully deregulated in 1997-98 and any formal or informal interest rate controls to be abolished.
- CRR (Cash Reserve Ratio) to be reduced in phases to 8 percent in 1997-98, 6 percent in 1998-99 and to 3 percent in 1999-2000.
- Gross Non-Performing Assets (NPA) as percentage to total advances to be brought down in phases to 12 percent in 1997-98, 9 percent in 1998-99 and to 5 percent in 1999-2000.
- 100 percent marked to market valuation of investment for banks.
- Best practices for forex risk management by banks.
- Banks to follow international accounting disclosure norms.
- Capital prescription be stipulated for market risks. (RBI 2001-02).

The Tarapore Committee report was a landmark in Indian economic history. It provided a comprehensive package to lead India on the road to capital account convertibility and integrate and globalize the Indian foreign exchange market with the world economy. But the major difficulty with the report was that it gave a period of three years only for capital account convertibility to be achieved. The period was too short and the pre-conditions and macro-economic indicators could not be achieved in such a short period. Therefore, the report remained largely fallow in terms of implementation. The emergence of East Asian Crisis in 1997 further dumped all expectations and again caged the policies of liberalization in India. Nevertheless, the spirit towards liberalization of capital account survived and over the years India took several measures in this direction. (Misra and Puri, 2009)

The problem of capital account convertibility was revisited in 2006, with expanded contours. The performance of Indian economy in past nine years (1997-2006) played a critical role in generating confidence among policy makers to wind back the Tarapore Committee Recommendations, with further modifications. In 2004, India became one of the fourth richest economies of the world in terms of purchasing power parity (PPP) index. Despite
stringent capital controls, India’s performance of capital account was stunning in terms of stupendous increase in non-debt capital inflows. This motivated India to go for full capital account convertibility to seek better access to international capital and achieve better integration of the Indian economy into the world economy. 

Dr. Y.V. Reddy, the then Governor of the Reserve Bank of India (RBI), in consultation with the Government of India, appointed, a committee under the chairmanship of the same Shri S.S. Tarapore on March 20, 2006, for setting out a roadmap towards Fuller Capital Account Convertibility. 

The terms of reference of the committee were:
To review the experience of various measures of capital account liberalization in India.
To examine implications of fuller capital account convertibility on monetary and exchange rate management, financial markets and financial system.
To study the implications of dollarization in India of domestic assets and liabilities and internationalization of the Indian rupee.
To provide a comprehensive medium-term operational framework, with sequencing and timing, for fuller capital account convertibility taking into account the above implications and progress in revenue and fiscal deficit of both centre and states.
To survey regulatory framework in countries which have advanced towards fuller capital account convertibility.
To suggest appropriate policy measures and prudential safeguards to ensure monetary and financial stability, and
To make such other recommendations as the Committee may deem relevant to the subject (Report on Fuller Capital Account Convertibility, 2006).

The Committee submitted its report to the RBI on July 31, 2006.

Taking lessons from cross country experiences in fuller convertibility on capital account, the committee suggested a number of pre-conditions for the success of capital account liberalization in India. These included a strong macroeconomic framework, sound financial systems and markets and prudential regulatory and supervisory architecture. It detailed a broad five-year frame for movement towards fuller convertibility in three phases:
- Phase II (2007-08 to 2008-09).
- Phase III (2009-10 to 2010-11).

It recommended the meeting of certain indicators/targets as a concomitant to the movement towards fuller convertibility of the rupee on capital account. These included:
Meeting FRBM targets; shifting from the present measure of fiscal deficit to a measure of the Public Sector Borrowing Requirement (PSBR);
Segregating Government debt management and monetary policy operations through the setting up of the Office of Public Debt independent of the RBI;
Imparting greater autonomy and transparency in the conduct of monetary policy; and slew of reforms in banking sector including a single banking legislation and reduction in the share of Government / RBI in the capital of public sector banks;
Keeping the current account deficit to GDP ratio under 3 per cent; and
Evolving appropriate indicators of adequacy of reserves to cover not only import requirements, but also liquidity risks associated with present types of capital flows, short-term debt obligations and broader measures including solvency.

Thus, since the early 1990’s, the Indian economy has been moving progressively towards integration into the global economy. The rupee is now fully convertible on the current account and considerable progress has been made in making it convertible on the capital account. However, the movement on the capital account convertibility have been rather slow and cautious. India believes that full convertibility on capital account is a process rather than a single event.

b) **Foreign Investment:** In order to invite foreign investment in high priority industries, requiring large investments and advanced technology, it was decided to provide approval for foreign direct investment (FDI) upto 51 percent foreign equity in such industries (Statement on Industrial Policy, 1991). This group of industries had generally been known as the "Appendix I Industries" and were areas in which FERA companies had already allowed foreign investment on a discretionary basis. This change was expected to go a long way in making Indian policy on foreign investment transparent. Such a framework would make it attractive for companies abroad to invest in India (Statement on Industrial Policy, 1991). The 51 percent level was chosen as this allowed foreign companies to amalgamate profits and losses from such a company into those of the parent company for tax purposes. Technology import was also put under the automatic route subject to conditions on royalty (< 5% domestic, < 8% export) and lump sum payment (< Rs. 1 crore) (Virmani, 2001; Virmani, 2004).

In the Industrial Policy Statement 1991 it was viewed that promotion of exports of Indian products called for a systematic exploration of world markets which was possible only through intensive and highly professional marketing activities. To the extent that expertise of this nature was not well developed in India, government pledged to encourage foreign trading companies to assist India in its export activities. Attraction of substantial investment and access to high technology involve interaction with some of the world's largest international manufacturing and marketing firms. The government decided to appoint a special board to negotiate with such firms so that India could engage in purposive negotiation with such large firms, and provide the avenues for large investments in the development of industries and technology in the national interest.

The liberalisation of Industrial Policy in 1991 introduced a two-way approval process for foreign direct investment. First was the automatic approval route which was applicable to all proposals where the proposed items of manufacture activity did not require an industrial license and was not reserved for the small-scale sector. The initial limit on foreign investment was 51 percent. The upper limit for foreign equity participation under automatic approval was raised from 51 to 74 percent of the equity capital {and 100 percent in case of Non-Resident Indian (NRI)} in select industries in January 1997. The list of industries open for automatic approval was also expanded. In the Budget Speech 1999-2000, it was announced that the scope of automatic approval would be expanded further.

If the foreign investors wanted to enter other industries or secure higher percentage of foreign equity for themselves, they had to go through a formal process of case by case approval by the government with the Foreign Investment Promotion Board (FIPB) playing the main role (Rao, Murthy and Ranganathan, 1999).

Additional liberalisation measures included amendment of the FERA to remove the general ceiling of 40% on foreign ownership in FDI projects; the ban on the use of foreign brand names in the domestic market was lifted;
the dividend balancing condition was withdrawn for all foreign investment approvals except for 22 industries in the consumer goods sector; export obligations were relaxed; the terms of technology and royalty agreements were liberalised; and the sectors reserved for the SSI were opened up for foreign investments up to 24% of equity ownership. In 1997, automatic route approval was expanded to 111 high priority sectors with various equity ownership limits between 50% and 100%. [OECD, (2009)].

The Foreign Investment Promotion Board (FIPB) was set up as the nodal, single window agency for all matters relating to FDI, with a view to promote FDI into India, [i] by undertaking investment promotion activities, [ii] facilitating foreign investment, [iii] purposeful negotiation/discussion with potential investors, [iv] early clearance of proposals, and [v] reviewing policy and putting in place appropriate institutional arrangements, transparent rules and procedures and guidelines for investment promotion and approvals.

The Secretariat for Industrial Assistance (SIA), Ministry of Commerce & Industry, provides a single window service for entrepreneurial assistance, investor facilitation, receiving and processing all applications, assisting entrepreneurs and investors in setting up projects (including liaison with other organisations and state governments) and in monitoring the implementation of projects.

Foreign Investment Implementation Authority (FIIA) provides a pro-active one stop after service care to foreign investors by helping them obtain necessary approvals, sort out operational problems and meet with various government agencies to find solution to their problems (Sahoo, 2006).

International Trade: - In the field of international trade, the basic objective of policy change has been the creation of an environment for achieving rapid increase in exports, raising India’s share in world exports and making exports an engine for achieving higher economic growth. The focus of these reforms has been on liberalization, openness, transparency and globalization with a basic thrust on outward orientation (Economic Survey, 2001-02). Major elements of these reforms have included the substantial reduction in import duties, and a drastic rationalization of tariff structure, dismantling of non-tariff barriers, measures to ensure adequate and timely availability of bank credit for trade finance at competitive interest rates, an appropriate institutional arrangement for supporting a vigorous export drive.

Trade reforms have also encompassed a vast range of tradable services. In view of the growing importance of the service sector in Indian economy, India’s stance towards General Agreement on Trade in Services (GATS) has changed considerably.

Liberalisation of imports was considered as pre-requisite for expansion of exports. On the eve of reforms, in 1990-91, the import-weighted average of tariffs for all import stood at 87% (with tariffs on some imports exceeding 300%). Import-weighted average tariffs on consumer goods imports were as high as 164%. In addition, some non-tariff barriers, particularly quantitative restrictions applied to virtually all imports. During the decades of reforms, import-weighted average tariffs declined to 24.6% by 1996-1997, only to increase to 30.2% by 1999-00, in part because of a surcharge of 10% on tariffs imposed in 1997-98 (World Bank, 2000). The surcharge was abolished in the budget for 2001-02. As of the fiscal year 2000-01, there were just four major tariff categories (35%, 25%, 15% and 5%), although most imports attract tariffs of 25% and 35%. Quantitative restrictions (QRs) on most imports have been abolished as of April 1, 2001. However, while abolishing QRs on agricultural imports, tariffs have been raised to high levels. While it is understandable that the agricultural sector, insulated for a long time from world
markets, would need time to adjust to possible competition from imports, raising tariffs to very high levels without at the same time indicating a time schedule for bringing them down to reasonable levels indicates an apparent lack of a firm commitment to further trade liberalization (Srininvasan, 2001).

1.3 Concluding Remarks

To conclude, the years after 1990-91 have witnessed some far-reaching changes in the approach to and conduct of India’s economic policy. The basic objective underlying the changes in policy has been to put the Indian economy on a sustainable path of high growth by freeing the economy from the state intervention either in the form of planning mechanism or various types of controls. The changes have fallen broadly under two categories: macroeconomic reforms and structural adjustments. The first group of measures have been directed at short term stabilization aiming at inflation control and wiping out of the balance of payments deficits. This is a short run facet of economic reforms focusing on demand management through reduction of fiscal deficits, rationalization of subsidies and cutting down of government expenditure. The second set of measures have dealt with structural reforms and directed towards long run improvements in the supply side of the economy. The programme has been wider ranging and involved all vital sectors of the economy. However, major reforms have been introduced in the external sector of Indian economy to accelerate the intensity of globalization.

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