ambitious baba .com

JAIIB (New Syllabus)

INDIAN ECONOMY & INDIAN FINANCIAL SYSTEM (IE&IFS).

Paper-1

MODULE-A, UNIT-7

ECONOMIC REFORMS

Paper IE and IFS Module A Unit 7: Economic Reforms

Economic Reforms

- Economic reform refers to the process, whereby, a government specifies a declining role for the state and an expanding one for the private sector in the economy.
- '**Economic reform'** usually refers to deregulation, or at times shrinking the size of government, to remove distortions caused by regulations or the presence of government, rather than new or enhanced regulations or government programmes to alleviate distortions caused by market failure.
- Historically, the reform process has seen the pursuit of market-oriented policies that foster private sector development—augmenting and controlling the market.

A Brief Overview

- Economic reforms aimed at expanding private sector participation in the Indian economy's growth process.
- Since 1980s, India has seen a number of changes that fit into 2 categories.
- The 1980s reforms, influenced by the renowned **'Washington Consensus' doctrine.**
    - While the changes of the 1980s saw very limited deregulation and partial liberalisation of just a few parts of the previous regulatory system
- The reforms that started in the early 1990s, in the domains of industry, commerce, investment, and, subsequently, agriculture, were considerably broader in scope

ambitious baba.com

1991 Economic reforms: Due to a number of economic factors, including.

- An adverse balance of payments,
- Poor performance of the public sector,
- Drop in foreign exchange reserves,
- Large government debts,
- Inflationary pressure
- Stringent conditions laid down by the World Bank and IMF

Transformation

The green revolution and industrial modernisation have transformed India's economy from an economic laggard to one of the world's fastest growing economies.

The term **'new economic reforms'** refers to the neoliberal policies put in place by the Indian government in 1991.

The three main pillars of this change were known as LPG

i)Liberalisation,

ii)Globalisation, and

iii)Privatisation

- The reforms intended to accomplish high economic growth, lowering inflation, minimise the current account deficit, and address the balance of payments issue.
- Policy changes were made in the areas of technology advancement, industrial licencing, abolition of restrictions on the private sector, foreign investments, and foreign trade.
- Attracting significant foreign direct investment was one of the key goals of the 1991 economic reform process.
- India's economic transformation reduced poverty throughout all socioeconomic categories, enhanced capacity in agriculture and industrial output. It also improved the socioeconomic indices and level of living among common people.

Economic Transformation-Real Sector

The economic changes introduced in India in 1991 were the result of a severe economic crisis caused by rising external debt. This crisis occurred mostly as a consequence of poor economic management in the 1980s. The reforms were broadly known as LPG reforms.

- **Liberalisation**: Liberalisation was conceived with the idea that regulations imposed on trade agreements must be relaxed, in favour for trade to thrive. It enabled the opening of economic frontiers, for international investors and multinationals. Several economic reforms enforced by Liberalisation, include enhanced production capacity, abolition of government industrial licencing, and the liberty to import goods.
- **Privatisation**: Privatisation refers to providing the private sector more opportunities to oversee various services, while limiting the role of the public sector. Privatisation introduced in India as a part of reform, invited more and more foreign participation and FDI flow, providing healthy competition to Indian goods and services.
- **Globalisation**: Globalisation in the context of economic reforms, refers to the integration of the Indian economy with the global economy. It signifies that India's economy will now be more dependent on the global economy and vice versa. It encourages FDI and international trade with various countries. Due to various globalisation policies, India could be able to **attract foreign capital, technology, and knowledge to boost its domestic capacity.**

Economic Transformation – Financial Sector

- **The primary goal of reform**: To establish an efficient, productive, and competitive financial services industry, functioning in an environment of operational flexibility and functional autonomy.
- **Banking sector reforms have aimed** at making the Indian financial sector efficient, competitive, and stable.

Until the 1990s, the Indian financial sector was characterised by

- Controlled interest rates,
- Significant pre-emption of resources by the government, and
- Extensive micro-regulations guiding the bulk of the flow of funds to and from financial intermediaries.

Banking Sector Reforms

Important Committee:

- Chakaravarti Committee on Monetary Policy (1985)
- Narsimham Committee-I on Financial Sector Reforms (1991),
- Padmanabhan Committee to Review Bank Supervision (1996),
- Narsimham Committee-II on the Review of Banking Sector Reforms (1997),
- Verma Committee on Weak Banks (1998),
- RH Khan Committee on Harmonisation of Role of FIs and Banks (1998).

Started with the introduction and phased implementation of prudential measures, implementation of competition-enhancing measures, augmentation of the role of market forces, introduction of institutional and legal measures like the formation of

  - Lok Adalats,
  - Debt Recovery Tribunals,
  - Asset Reconstruction Companies,

- Introduction of supervisory measures, the introduction of technological advancements, etc.
- These reforms aimed at establishing a framework of prudential regulation and supervision.
- Non-Banking Financial Companies (NBFCs) have also been subjected to competition and efficiency enhancing policies.

First Phase of Reforms – The Narasimham Committee I (February 1992)

- **"The Committee on Financial System" (CFS**) under the **Chairmanship of M. Narasimham:** Appointed by GoI
- To rebuild the financial health of commercial banks and to make their functioning efficient and profitable.
- Based on the committee's recommendation, the RBI, in February 1992, issued the new guidelines on Income Recognition, asset classification and provisioning requirements. The new standards put the banking sector's attention to credit risk and recovery management.

Few of the important reforms that took place in 1992 were:

- Capital adequacy norms
- Progressive reduction of Cash Reserve Ratio and Statutory Liquidity Ratio
- Deregulation of Lending rates
- Credit delivery
- Debt Recovery Tribunal (DRT)
- Strong Supervisory System
- Entry of New Private Banks
- Mergers and Amalgamation.

Second Phase of Reforms – Narasimham Committee-II

- In 1998, the Government set up Committee on Banking Sector Reforms in India under **the chairmanship of M. Narasimham**
- **Purpose: T**o review the progress of banking sector reforms to date and chart a programme of financial sector reforms necessary to strengthen the Indian Financial System and make it internationally competitive. The benefits of the

Second Phase of Banking Sector Reforms

- Deregulation of Branch Licensing
- Prudential Norms and Disclosure Requirements
- Capital Adequacy

The following points are important milestones of banking sector reforms:

Prudential reforms

- Prudential reforms include the phased implementation of international best practices and rules, in order to lower the total risk of the banking system.
- Adoption of measures under Basel II are examples of such steps.

Focus areas:

i)NPAs

ii)Capital adequacy

iii) Diversification of operations

Measures:

- Risk-weighted CAR,
- Appropriate accounting norms,
- Recognition of different components of risk,
- Assignment of risk-weights to various asset classes,
- Application of the marked-to-market principle for investment portfolio
- Limits on fund deployment in sensitive activities, and migration to advanced methods
- With a view to directing the resources of banks to the niche areas and to sustain efficiency in the banking system a graded approach of bank licensing was introduced and creation of differentiated banks in India was announced in the Union Budget 2014.

Supervisory reforms

- **Several steps were taken to strengthen supervisory reforms in the banking sector, including:**
  - Establishment of the Board for Financial Supervision, as the apex supervisory authority, for commercial banks, FIs, and non-banking financial companies
  - Implementation of the CAMELS supervisory rating system, the transition to risk-based supervision,consolidated supervision of financial conglomerates;
  - Recasting of the role of statutory auditors, increased internal control through strengthening of internal audit.
  - Strengthening corporate governance, enhanced due diligence on important shareholders, fit and proper tests for directors.

Note:

- C—Capital adequacy,
- A—Asset quality,
- M- Management,
- E—Earnings,
- L—Liquidity

Competition reforms

- Prior to reform, banks in India were uncompetitive and inefficient, due to excessive government control and limited access for private and foreign sector banks. The government extended PSBs operational autonomy and lowered public ownership in such banks, through reform measures that allowed them to obtain capital from **the stock market, up to 49% of paid-up capital.**

- Private and international banks have been permitted to operate in India, in order to foster a culture of competition and greater choice.
- Transparent norms for entry of Indian private sector, foreign and joint-venture banks and insurance companies, permission for foreign investment in the financial sector in the form of **Foreign Direct Investment (FDI) as well as portfolio investment (FPI)** permission to banks to diversify product portfolio and business activities.

Market reforms

- **Market reforms include the removal of administered interest rate measures, the reduction of CRR and SLR** rates from previously higher levels, the discontinuation of ad hoc treasury bills and market determined pricing for government securities, the establishment of a pure inter-bank call money market, the implementation of auction-based repos-reverse repos for short-term liquidity management, and the facilitation of improved payments and settlement mechanisms.
- **Sharp reduction in pre-emption** through reserve requirement, market determined pricing for government securities, disbanding of administered interest rates with a few exceptions and enhanced transparency and disclosure norms to facilitate market discipline.
- **Introduction of pure inter-bank call money market**, auction-based repos-reverse repos for shortterm liquidity management, facilitation of improved payments and settlement mechanism.

Institutional and legal reforms

Institutional reforms in Indian banking includes:

- **Establishment of the Credit Information Bureau :** for the information exchange on defaulters as well as other borrowers;
- **Establishment of the Clearing Corporation of India Limited (CCIL):** to act as a central counter party in the payments and settlement system for fixed income securities and money market instruments.
- **The Banking Ombudsman Scheme**: established in 1995, provides a quick and lowcost venue for bank clients to resolve grievances.
- **The enactment of the Insolvency and Bankruptcy Code, 2016** and the announcement of the recapitalization plan for the public sector banks are likely to have far-reaching implications for the banking sector. Both will likely contribute to a stronger and more resilient banking sector in India**.**

The establishment of

- Lok Adalats
- Debt Recovery Tribunals,
- Asset Reconstruction Companies,
- Settlement Advisory Committees,
- Corporate Debt Restructuring Mechanisms and so on

To facilitate faster recovery/restructuring.

- Adoption of **the Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI**) Act and
- Subsequent amendments to protect creditors' interests.

Technology reforms

- Technology improvements include the establishment of INFINET as the financial sector's communication backbone, as well as the implementation of the **negotiated dealing system (NDS**) for screen-based trading in government securities and the **real-time gross settlement (RTGS) system.**
- **The use of ATMs,** card-based transactions, internet banking, mobile banking, national electronic fund transfer, express cheque clearing process (ECCS), and other technologies has changed the role of Indian banking.
- **A High-Level Committee (chaired by Dr. K.C. Chakrabarty**) with representatives from IIT, IIM, IDRBT, banks, and the Reserve Bank created the "IT Vision Document—2011–2017" for the Reserve Bank and banks, which provided road map for increased IT usage in the banking industry.
- New age technologies such as Artificial Intelligence (AI) and Machine Learning (ML) have radically shifted the way banking works today. Thanks to AI, it is possible to conduct real-time data analysis from a large volume of data sets and provide customized solutions to banking customers
- While the Digital India revolution catalyzed by ***PMJDY, e-KYC and UPI*** has led a paradigm shift in the way India interacts with and consumes financial services. (PMJDY, launched in 2014, has witnessed 420 million bank accounts opened till date. 'JAM' (Jan Dhan-Aadhaar-Mobile) trinity has been a game changer for India, enabling them to take forward financial financial inclusion in a futuristic format.
- **Direct Benefit Transfer or DBT** has travelled a long path since its early initiation by **Government of India on 1 January 2013 to** change the mechanism of transferring cash subsidies and benefits with the help of technology.

Debt Market Reforms

Institutional measures include

- Integration of an auction system for price discovery,

- Addition of more instruments to the Government Securities Market,
- Enabling measures such as allowing foreign institutional investors (FIIs) to invest in Government Securities,
- Introduction of automated screen-based trading in Government Securities,
- Institutionalization of trading in government securities on stock exchanges,
- Formation of Primary Dealers in the government securities market.

91-day Treasury bill was introduced for managing liquidity and benchmarking.

- Zero Coupon Bonds, Floating Rate Bonds, Capital Indexed Bonds were issued and exchange traded interest rate futures were introduced.
- OTC interest rate derivatives like IRS/FRAs were introduced**.**

- **Foreign Institutional Investors (FIIs) :** Allowed to invest in government securities subject to certain limits.

Introduction of automated screen-based trading in government securities through Negotiated Dealing System (NDS).

- Setting up of risk-free payments and settlement system in government securities through Clearing Corporation of India Limited (CCIL).
- Phased introduction of Real Time Gross Settlement System

- **Introduction of trading of government securities on stock exchanges for promoting retailing in such securities, permitting non-banks to participate in repo market.**
- **For ensuring transparency in the trading of government securities, Delivery versus Payment (DvP) settlement system was introduced.**
  - **Repurchase agreement (repo) :** tool of short-term liquidity adjustment.
  - **Liquidity Adjustment Facility (LAF) was introduced.**
- LAF operates through repo and reverse repo auctions to set up a corridor for short-term interest rate.
  - Tool for both liquidity management and also signaling device for interest rates in the overnight market.
- **Market Stabilization Scheme (MSS):** expanded the instruments available to the Reserve Bank for managing the surplus liquidity in the system**.**

Foreign Exchange Market Reforms

The most significant reform in the currency market was the transition from a single currency fixedexchange rate system to controlling the level of the rupee against a basket of currencies, then to a market-determined floating exchange rate system.

- Adoption of rupee convertibility for current account transactions, institutional framework by replacing the earlier **Foreign Exchange Regulation Act (FERA), 1973 with the Foreign Exchange Management Act, 1999,** increase in foreign exchange market instruments, development of the rupee-foreign currency swap market, introduction of additional hedging instruments, such as foreign currency-rupee options, and permission to various participants in the foreign exchange market.
- Banks are also permitted to fix interest rates on non-resident deposits, subject to certain specifications, use derivative products for asset-liability management and fix overnight open position limits and gap limits in the foreign exchange market, **subject to ratification by RBI.**
- Permission to various participants in the foreign exchange market, including exporters, Indians investing abroad, FIIs, to avail forward cover and enter into swap transactions without any limit subject to genuine underlying exposure.
- FIIs and NRIs permitted to trade in exchange-traded derivative contracts subject to certain conditions.

Insurance Sector Reforms

- Following the passing of the **Insurance Regulation and Development Act, in 1999,** various reforms were introduced in the domestic insurance sector, including the possibility for emerging players/ joint ventures to undertake insurance business on a risk-sharing/commission basis**. The Insurance Regulatory and Development Agency (IRDA)** was created, to govern and oversee the insurance industry.
- Along with the changing product profile, there have also been salutary improvements in consumer service in recent years, driven largely by the impact of new technology usage, better technical know-how consequent upon foreign collaboration and focused product targeting, dovetailed to specific segments of the populace as well as cross-**selling of products through Bancassurance**.
- Insurance companies are also taking active steps to venture into innovative distribution channels for their products over and above creating strong agency network.

Capital Market Reforms

- A package of reforms containing measures **to liberalize, regulate, and expand the capital market** was introduced with the goal of improving market efficiency, increasing transparency, integrating national markets, and preventing unfair trade practices.

- **Regulator**: Securities and Exchange Board of India (SEBI). Since 1992, stock market reforms have primarily focused on regulatory effectiveness, enhancing competitive environments, eliminating information asymmetry, developing modern technological infrastructure, minimizing transaction costs, and limiting speculation in the securities market.

- The liberalization and consequent reform measures have drawn the attention of foreign investors leading to a rise in portfolio investment in the Indian capital market.
- In 1992, the Indian stock market was opened to **foreign institutional investors (FIIs). Through American Depository Receipts (ADRs), Global Depository Receipts (GDRs), Foreign Currency Convertible Bonds (FCCBs), and External Commercial Borrowings (ECBs),** the Indian corporate sector was granted access to international capital markets.

Establishment of Creditors Rating Agencies;

- Increasing of Merchant Banking Activities;
- Rising Electronic Transactions;
- Growing Mutual Fund Industry;

Establishment of clearing house;

- Rolling Settlement;
- Investor's Protection;
- Growth of Derivative;
- Commodity Trading;
- IPO Grading;
- Migration of Mutual Funds from commission based system to free based system;
- Margin Trading are few of the important reforms that have taken place in the Capital Markets.

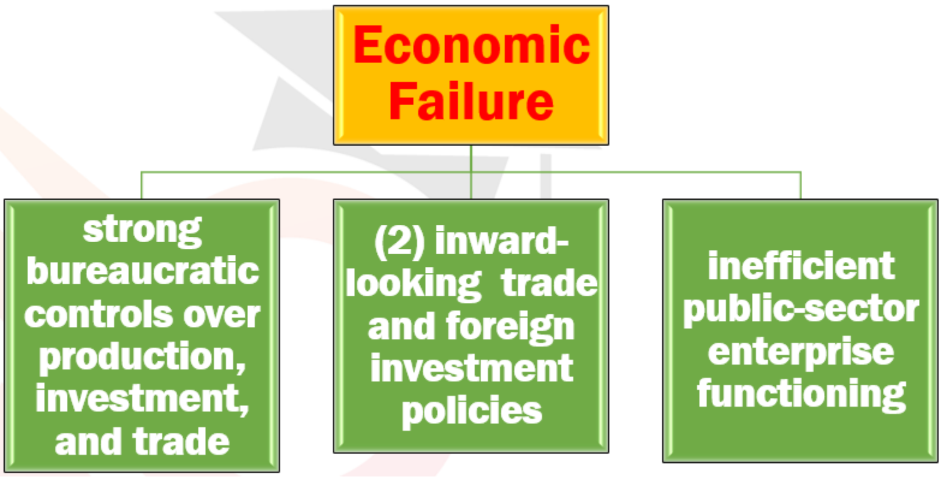
Economic Transformation Integration With The Global Economy

After nearly five decades of isolation from global markets, government controls, and slow growth, India started the process of economic reform and increasing integration with the **global economy in 1991**, to place its economy on a path of fast and sustainable growth. Despite major shifts in administration since then, the emphasis on reforms has persisted. Notwithstanding the perception of India as a relatively closed economy, India has made significant progress on the path of international integration in both trade and finance.

- **Since the early 1980s,** India's integration with the global economy has increased in line with the acceleration of economic growth.
- International trade (the sum of exports and imports of goods and services expressed in percentage of GDP) **has increased from 15.5 per cent of India's GDP in 1991 to 55.6 per cent in 2011.**
- As GDP growth has recently outpaced trade growth, the ratio has dropped to **37.9 per cent by 2020.**
- Meanwhile, net inflows of foreign direct investment (FDI) have risen **from 0.03 per cent of GDP in 1991 to 2.42 per cent in 2020.**
- The substantial inflow of foreign investment into India in recent years, reflects the country's strong economic potential and the execution of important policy reforms.

Economic Reforms In India

- Reforms in India have a history and reflect the Indian economy's poor upbringing over decades, which finally culminated to the 1990s economic catastrophe.
- The causes that underlie India's economic disaster have been clearly outlined by **Jagdish Bhagwati.**
- **He categorises India's economic failure into three categories:**



The following points can explain the economic crisis of 1990:

Higher fiscal deficit:

- An economy's fiscal health reflects the quantity and quality of government expenditure as well as revenues.
- **Overspending leads** to increased borrowing and interest costs. The government's ever-increasing non-developmental expenditure harmed its economic health, eventually increasing the fiscal deficit

Early 1980	**5.1% of GDP**
1990-91	**8.4% of GDP**

The government borrowed to reduce the fiscal deficit, causing the domestic debt to rise:

Early 1980	**33% of GDP**
1990-91	**Over 50% of GDP**

It increased the burden of debt payment from **2% to 3.8% of GDP**.

Adverse balance of payment situation: The current account deficit in India increased

1980-81:	**1.35% of GDP**
1990-91:	**3.69% of GDP**

Reasons:

- Poor economic policies, such as import substitution and trade restrictions.
- Drop in foreign remittances from Arabian nations as a result of the gulf crisis.
- The unstable coalition administration at the centre, as well as political instability, harmed the confidence of foreign creditors, particularly non-resident Indians (NRI), resulting in an outflow of NRI deposits.
- **To lower the foreign exchange deficit**, the government resorted to external borrowing, and as a result, India's external debt increased from

1980-81	**12% of GDP**
1990-91	**23% of GDP**

The increase in foreign borrowing increased the debt payment burden from

1980-81	**15% of Export revenue**
1990-91	**30% of Export earning**

Foreign exchange reserves fell to a low of US$1.2 billion (equivalent to two weeks' worth of imports). India faced bankruptcy, as it failed to satisfy its foreign debt obligations.

High inflation rates

- **Double-digit galloping inflation:** During 1990–1991, the Indian economy experienced

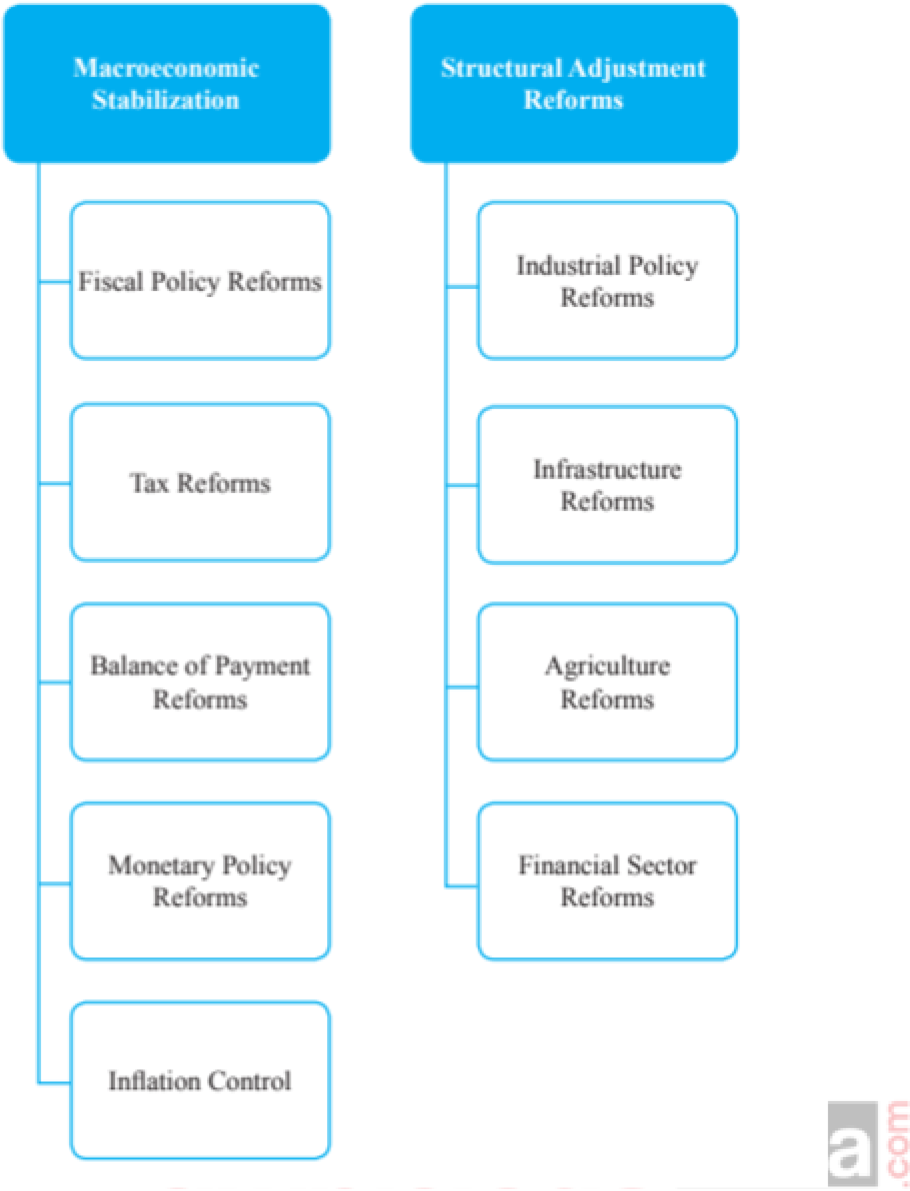
While the average annual rate of inflation

1980-89	**6.4%**
1990-91	**11.3%**

Cause: Huge increase in prices was the massive scale deficit financing (and subsequent increase in money supply) carried out throughout the 1980s**.**

Poor industrial and agricultural productivity also led to supply-side constraints and inflation.

Globalisation is genuinely helpful, but it must be properly controlled to reap the benefits. India's experience of gradual and calibrated capital account liberalisation has helped protect it against external shocks to a certain extent. International investors' growing trust in the Indian economy is a consequence of significant policy reforms, liberalisation of foreign investment laws, and improved fiscal and monetary management.



- Join Telegram Group
- **For Mock test and Video Course Visit: test.ambitiousbaba.com**
- **Join Free Classes: JAIIBCAIIB BABA**
- **Download APP For Study Material: Click Here**


JAIIB MAHACOMBO
Latest Syllabus
Indian Institute of Banking & Finance
Mock test
Unit-wise & Full length Mock
Video Course
Unit-wise class
Details Explanation
Download our Android App Now
For Mock Test & Video Course
Visit: test.ambitiousbaba.com
Jaiib.caiib
JAIIBCAIIB Baba
Telegram- @jaiib_exam