UNIT 15 ECONOMIC POLICIES

Structure

15.0 OBJECTIVES

After completion of this unit, you should be able to :

- explain the objectives and salient features of Industrial Policy Resolution 1956;
- enumerate the changes in industrial policy that took place during 1970s and 1980s;
- explain the salient features of New Industrial Policy of 1991;
- evaluate the contribution of new industrial policy to acceleration of industrial growth and raising the industrial efficiency;
- explain the concept of fiscal policy and its objectives;
- describe the long-term fiscal policy (1985-90);
- discuss the current volatile situation and the fiscal approach;
- explain the concept of monetary policy and its objectives;
- describe the working of the monetary policy in pre 1990-91 period; and
- discuss the changes in the monetary policy in the liberalisation phase and the impact thereof.

15.1 INTRODUCTION

The Indian economy at the time of independence was highly underdeveloped and the level of national income was low. The economy had literally stagnated during the pre-independence period. It was essentially agrarian in character with little development of basic and capital goods industries. The government took these objective realities into consideration while framing its economic policies after independence. Since India decided to follow its development path in the mixed economy framework, it assigned a crucial role to the public sector in industrial development and designed well coordinated state polices to effect the structural changes in the system of production and distribution. Operating with resource constraint, the government had to rely mainly on fiscal tools for resource mobilisation. But, the economic crisis which overwhelmed this country in 1990-91 and the liberalisation, privatization and globalisation policies persued thereafter, completely changed the basic framework of economic policy making and required significant changes in industrial and monetary policies. In this unit you will learn in detail about the three important economic policies, viz., the industrial policy, the fiscal policy, and the monetary policy which played a crucial role in accelerating the economic growth and speed up the industrial development in India during the last five decades.

15.2 INDUSTRIAL POLICY

Industrial policy refers to all those procedures principles, rules and regulations which control the industrial undertakings of a country and shape the pattern of its industrialisation. In India, the government issued the first industrial policy immediately after independence in April, 1948. The Industrial Policy Resolution of 1948 contemplated a mixed economy in which both private and public enterprises would march hand in hand to accelerate the pace of industrial development. It also accepted the importance of small and cottage industries for their usefulness in creation of employment.

15.2.1 Industrial Policy Resolution, 1956

After completing the First Five Year Plan, the need was felt for a new industrial policy resolution conforming to broader goals of economic planning. Accordingly, the second Industrial Policy Resolution was passed in April, 1956. It laid down the following objectives to be achieved through this policy:

1 to accelerate economic growth and speed up the industrial development;
2 to develop heavy industries and capital goods industries;
3 to expand public sector;
4 to prevent growth of monopolies and concentration of economic resources and power; and
5 to reduce income and wealth inequalities.

Salient Features

The Industrial Policy of 1956 provided a comprehensive framework for industrial development over a period of two decades. Its salient features were:

1 **Division of industrial sector :** The Industrial Policy Resolution of 1956 divided industries into the following three categories :

(a) *Industries to be developed exclusively by the state :* Seventeen industries listed in Schedule A appended to the Industrial Policy Resolution were included in the first category. All these industries were to be developed in future by the state. Of these, four industries, viz., arms and ammunition, atomic energy, railways and air transport were made government monopolies. In case of the remaining 13 industries, while the new industrial units were to be set up in the public sector, the existing units in the private sector were allowed to operate and grow without any threat of the takeover by the state.

(b) *Mixed sector comprising both public ahd private industrial units :* Twelve industries listed in Scheduled B were included in this category. These were other minerals, road transport, sea transport, machine tools, ferro-alloys and tool steels, antibiotics and other essential drugs, synthetic rubber, festiliers, chemical pulp, carbonisation of coal, and aluminum and other non-ferrous metals not included in the first category. In the mixed sector, the government was expected to have an increased role. At the same time private sector was not to be denied opportunities to set up new units or expand capacity in the existing units.

(c) *Industries left open to the private sector :* All industries not listed in Schedule A or B were left for the private sector Although the state could set up a unit in these industries, the main initiative had to come from the private sector for developing industries included in this category. The main responsibility of the state in respect of these industries was to provide facilities to the private sector so that it could expand its industrial activity.

2 **Coexistence and mutual cooperation of public and private sectors :** The 1956 Industrial policy Resolution did not make public and private sectors mutually exclusive and independent of each other. The government could set up units even in industries reserved for the private sector and allow private enterprise to establish industrial units in the sector reserved for itself. Only arms and ammunition , atomic energy, railways and air transport were exclusive domain of the government. The 1956 Industrial Policy Resolution authorized the government to assist the private enterprises in its growth both directly through participation in their share capital and indirectly by providing fiscal incentives etc.

3 **Government reputation and control of private sector :** The 1956 Industrial Policy Resolution did not allow the private sector to pursue goals which were in conflict with the policy of the state. The private enterprises could indeed be return maximisers, yet they had to conform to economic and social policy of the state. Thus, the operations of the private sector were made subject to various government regulations and controls

4 **Reduction in regional disparities :** Until mid-fifties there was uneven development of the Indian economy. In order to overcome this problem, the 1956 Industrial Policy Resolution advocated industrial development, particularly in the backward regions. It also stressed infrastructural development in backward regions in order to facilitate setting up of new industries in these regions.

5 **Recognising the importance of small-scale and cottage industries :** Like the 1948 Industrial Policy Resolution, the 1956 Industrial Policy Resolution also recognised the importance of small-scale and cottage industries. These industries use labour intensive technology. Therefore, their capacity to generate employment opportunities is far more than that of the large scale industries. Moreover, they prevent concentration of wealth and economic power and have a positive role in mobilisation of human and physical capital. Considering all these merits of small-scale and cottage industries, the 1956 Industrial Policy Resolution made out a strong case for government assistance, both direct and indirect, to these industries.

6 **Industrial peace :** The 1956 Industrial Policy Resolution emphasised the role of industrial peace in industrialization. Recognising the fact of exploitation of workers by the industrial employers, the Resolution emphasised the need of protecting workers' rights. It thus advocated that workers should be provided the required amenities and incentives for carrying out their work. Workers' participation in management was considered a desirable step towards congenial atmosphere in the industrial sector.

7 **Technical and managerial personnel :** India faced shortage of technical and managerial personal when it emphasised on the path of industrial development immediately after the independence. The 1956 Industrial Policy Resolution thus advocated setting up of technical and managerial institutions and introduction of management and engineering courses in universities with the expectation that, in course of time, these measures would adequately meet the demand for technical and managerial personnel.

To be brief, the basic objective of the 1956 Industrial Policy Resolution was to strengthen the mixed economy structure in the country. In this respect, its approach was more or less the same as that of the 1948 Industrial Policy Resolution. But, it was more flexible, and enlarged the scope of the public sector.

Critical appraisal

The 1956 Industrial Policy Resolution by assigning a critical role to the public sector reflected the correct strategy for rapid industrial development. It provided an overall sense of direction and appropriate thrust to industrialisation. It aimed at building up a strong industrial base on which further industrial development could become sustainable. However, industrialists did not favour the important role that was assigned to the public sector. They wanted public sector to remain merely a facilitator of development in the private sector; anything beyond this was not acceptable to the latter. The 1956 Industrial Policy had also taken into account the linkages between the growth in the public sector and employment. Moreover, the stress on reduction in regional inequalities and development of small and cottage industries was justified on considerations of equalitarianism.

At the implementation level, however, the spirit of the 1956 Industrial Policy Resolution was blatantly violated. In a class society that India has always been, it was not surprising that licenses were issued to private concerns to establish units even in areas that were exclusively reserved for the public sector. While the private sector was provided unwarranted encouragement, the industrial units to be set up in the public sector were deliberately delayed. According to D. K. Ragnekar, "Proposals for setting up state owned steel mills were held back for years (in the earlier phase) in preference to the expansion of the private units. Schemes for setting public sector units in new fields were watered down under pressure for private sector participation, association or continuance".

15.2.2 Developments During 1970s and 1980s

For about one and a half decades, the 1956 Industrial Policy Resolution provided a broad framework for industrial development in India. However, by the end of the sixties there was complete disillusionment with the strategy of economic planning. Hence, the need was felt for making amendments in the Industrial Policy of 1956. During the 1970s, though the government continued to express its allegiance to the 1956 Industrial Policy Resolution, there were significant departures from its basic approach.

In 1973, the Government accepted the proposals of Industrial Licensing Policy Enquiry Committee (commonly known as the Dutt Committee) for setting up the joint sector. The joint sector was conceived as a sector in which besides the government involvement in production activity there had to be active participation of the state in management. However, the concept of joint sector remained hazy and at no point of time serious attempt were made to develop this sector. With the ascendancy of the neo-liberal ideology when the state started withdrawing from the industrial sector, the idea of joint sector was practically abandoned.

Another important departure from the 1956 Industrial Policy was significant concessions to domestic private sector units and the foreign multinational companies.. In 1973, the government prepared a list of 19 industries whose development was considered to be of fundamental importance to the country. These industries were mainly of three types, viz., core industries of importance to the national economy, industries having direct linkages with core industries, and industries with long term export potential. These industries were opened to the MRTP and FERA companies. To begin with, mainly the basic, large investment, and complex technology industries were included in the list. Later on, the Government continued modifying the list and added many new industries to it. As a result of this policy shift, the public sector was consistently undermined while the growth of the private sector was unfettered.

Industrial Policy Statement of July 1980 reiterated the Industrial Policy Resolution of 1956. But, nevertheless, it marked significant departures from the latter. The main emphasis of the 1980 policy statement was on optimum utilisation of installed capacity and expansion of existing industries. This approach was expected to facilitate rapid increase in industrial production. It also aimed at solving the problems arising from shortages of principal industrial inputs. For this purpose, the 1980 policy statement extended the provision of automatic expansion to more industries and recognised actually installed capacity for more than thirty industries. The government thus ignored legal violation by many industrial units operating in the private sector. The government defended its action on the ground that it helped in accelerating the process of industrial development.

During the eighties, the industrial policy was drastically changed and the following steps were taken to liberalise it:

1 **Raising limit of exemption for licensing :** The exemption limit from licensing was fixed at Rs. 3 crore in 1978. During the eighties it was continuously revised upwards. In 1983 it was first raised to Rs. 5 crore and then in 1988-89 to Rs. 15 crore for industrial units to be located in non-backward areas and Rs. 50 crore for units to be established in backward areas.

2 **Delicensing :** In pursuance of liberalisation policy, the government delicensed 28 broad categories of industries and 82 bulk drugs and their formulations. However, the MRTP and FERA industries did not get the benefit of this concession. Moreover, industrial units located in specified urban areas and the undertakings wanting to produce articles reserved for small scale sector were not covered under delicensing provision. In the late eighties, some more industries were delicensed.

3 **Relaxations to MRTP and FERA companies :** Companies falling under the MRTP and FERA were granted a number of concessions. Of these, the important ones are : (1) the MRTP companies were allowed to set up new capacities in industries of high national importance, or industries with import substitution potential or industries using sophisticated technology; (2) the limit for MRTP company was raised from Rs. 20 crore to Rs. 100 crore. Thus a large number of industrial companies earned the status of non-MRTP company; and (3) large industrial houses and companies governed by FERA were allowed unrestricted entry into 21 high technology items of manufacture. Besides these major

relaxations, some other concessions such as regularisation of excess capacity, endorsement of capacity, and facilities to set up industries in backward areas were granted to MRTP and FERA companies.

4 **Capacity rendorsement :** The scheme of capacity endorsement was announced in April 1982. In 1986, the scheme was further liberalized to enable industrial undertakings with 80 per cent of capacity utilisation to avail capacity rendorsement facility. Moreover, the number of industries for which the facility of automatic rendorsement of capacity was not available, was reduced from 77 to 26.

5 **Broad-banding of industries :** The government introduced the scheme of broad-banding in 1984. Under broad-branding, industries were classified under broad categories. This enabled industrial units to change their product mix in accordance with changes in demand patterns without procedural hassles. Broad-banding was extended over time to cover 45 broad categories of industrial products.

6 **Minimum economic scale of operations :** In 1986, the government decided to give industrial license for the optimum scale of operation. In pursuance of this approach, minimum economic scales of operation were determined for various industries. With this provision, the Government encouraged expansion of existing industrial units in order to realise the economies of scale.

7 **Development of backward areas :** In order to promote industrial development in backward areas, two significant policy decisions were taken by the government. First, the government extended the scheme of delicensing to MRTP and FERA companies in respect of a number of industries for location in backward districts. Second, the government decided in 1988-89 to set up 100 growth centres over a of period five years. These centres were required to overcome infrastructural problems in backward regions.

8 **Enhancement of investment limit for small scale industries :** The 1956 Industrial Policy resolution had reserved certain products for small scale industries and also ensured some direct and indirect assistance for their development. In order to broaden the coverage, the July 1980 Industrial Policy raised the investment limit for small scale industries to Rs. 20 lakh. This limit was raised further to Rs. 35 lakh in March, 1985 and to Rs. 60 lakh in April, 1991.

9 **Incentives for export promotion :** During the 1980s, the government announced various concessions in its industrial policy for export promotion. First, the MRTP and FERA companies were allowed to expand their capacity if their products were predominantly for export. Second, all 100 per cent export industries set up in the Free Trade Zones were exempted from certain stringent provisions of the MRTP Act. Third, some other industries considered important from export angle were allowed automatic growth of 5 per cent per annum over and above the permissible limit.

15.2.3 New Industrial Policy, 1991

The New Industrial Policy announced on July 1991 deregulated the Industrial economy in a big way. It was an attempt in line with the liberalisation measures already undertaken by the government during 1980s. It was aimed at attaining the following objectives :

1 to build future industrial development on gains already made;

2 to correct distortions and weaknesses that might have developed over time in the industrial structure;

3 to maintain a sustained growth in industrial productivity and employment; and

4 to attain international competitiveness.

Salient Features

The government announced the following policy measures in order to pursue the proclaimed objectives of the new industrial policy.

1 **Abolition of industrial licensing :** The New Industrial Policy abolished industrial licensing except for certain industries related to security and strategic concerns, social reasons and products of hazardous nature. Compulsory licensing was limited to only 6 industries. These are : alcohol, cigarettes, hazardous chemicals, electronics aerospace and defense equipment, drugs and pharmaceuticals (excepting bulk drug industry which has been delicensed), and industrial explosives. No approval is required in respect of industries which have been delicensed.

2 **Dilution of public sector's role :** The 1956 Industrial Policy Resolution had reserved 17 industries for the public sector. The 1991 Industrial Policy reduced this number to 8. Subsequently, five more industries were deleted from the reserved list. Thus, as of now, only 3 industries are reserved for the public sector. These are : (1) atomic energy, (2) minerals specified in the schedule to the atomic energy (1953), and (3) rail transport. The enterprises in the public sector have been provided a greater degree of management autonomy. The government is reducing its stake in public enterprises through divesting part of its shareholding. Over the period 1991-92 to 2000-02, the government raised Rs. 26,139 crore through disinvestment.

3 **Scrapping the threshold limit of assets in respect of MRTP undertakings :** Under the MRTP Act, all firms having assets valuing a specified amount were characterised as MRTP firms. These firms were permitted to enter selected industries only. The government committed to neo-liberalised policy had no difficulty in permitting these enterprises to grow and diversify their activities even if it led to industrial concentration. The New Industrial Policy, therefore, dropped the concept of MRTP firms.

4 **Free and liberal entry to foreign investment and technology :** Annexure III appended to the 1991 Industrial Policy Resolution provides a list of high technology and high priority industries wherein automatic permission is made available for direct foreign investment upto 51 per cent foreign equity. Subsequently, the government announced guidelines for expeditious approval of foreign investment is areas not covered under automatic approval. During 1999-2000, the government decided to put all industries under the automatic route for foreign direct investment / NRI and OCB investment except for a small negative list. The main aim of the major policy initiative is to facilitate foreign direct investment in infrastructure sector, core and priority sectors, export oriented industries and linkage with agro and farm sectors.

5 **Liberalisation of industrial location policy :** The 1991 Industrial Policy marked a significant departure from the earlier industrial location policy. The New Industrial Policy provided that for setting up industrial units in cities with less than

1 million population, the approval from the Central Government will not be required except for industries subject to compulsory licensing. Industries, other than those of non-polluting nature could be located outside 25 kms. of the periphery of the cities with 1 million population or more.

6 **Abolition of phased manufacturing programmes for new projects :** Phased manufacturing programme was meant to increase the pace of indegenisation in manufacturing. Under this system, local content requirements were enforced on a case by case administrative basis. The 1991 Industrial Policy Resolution abolished phased manufacturing programme because the government felt that this system was in conflict with the liberalisation policy which it had decided to pursue. However, incentives that were provided to manufacturing units with the prevailing phased manufacturing programmes were continued.

7 **Removal of mandatory convertibility clause :** Because of the private companies inability to raise funds from the capital market, they depended in a big way on banks and other financial institutions for industrial investment. The financial institutions including banks followed a practice of including mandatory convertibility clause in their agreements with the borrowing firms. This clause provided financial institutions an option of converting part of their loans into equity if their management considered it necessary. The financial institutions rarely exercised this option but the private borrowing firms disliked it as they interpreted it as a threat of takeover by the former. The 1991 Industrial Policy Resolution provided that henceforth financial institutions would not impose mandatory contestability clause on the borrowing private firms.

Critical appraisal

The New Industrial Policy fulfilled a long felt demand of the corporate sector for abolition of licensing for most industries and remove the limit of assets fixed for MRTP companies and dominant undertakings. This should have helped them to establish new undertakings and effect plans for expansion and thus accelerate industrial production. Further, it was expected that with the deregulation of the industrial sector and dilution of the MRTP Act industrial efficiency would increase, and the changes in respect of foreign investment and foreign technology would attract capital, technology and managerial expertise from abroad and thereby induce industrial growth. However, the practical experience of the industrial activity since the adoption of the new industrial policy has belied all claims that had been made by the government. The 1991 Industrial Policy has invited scathing criticism on the following grounds.

1 Average rate of growth of industrial production has declined from 7.8 per cent per annum during the 1980s to 6.6 per cent per annum during the 1990s. Moreover, the rate of industrial growth has been very much erratic since the announcement of the New Industrial Policy. The performance of the capital goods sector has been particularly disappointing over the past one decade.

2 Significant distortions have cropped up in the industrial sector as a result of implementation of the new industrial policy. Emphasis on privatization has led to a rapid growth the durable consumer goods sector , but the rate of growth of capital goods industries has plummeted from 9.4 per cent per annum during the 1980s to only 5.4 per cent per annum during the 1990s.

3 The New Industrial Policy has provided extensive opportunities to the MNCs to capture Indian market. The Indian industrial enterprises suffer from size

3 The New Industrial Policy has provided extensive opportunities to the MNCs to capture Indian market. The Indian industrial enterprises suffer from size disadvantages as they are too small in comparison with MNCS. Moreover, once foreign capital has free entry, the distinction between high priority and low priority industries disappears and there is a possibility that all lines of production may be opened to foreign investment.

4 The faith in foreign investment is misplaced. As yet, there is no evidence to show that foreign investment has helped in expanding export market. Despite various incentives, the MNCs have operated as trading concerns rather than manufacturing and exporting concerns. Besides, excessive freedom to foreign capital may ultimately affect our economic sovereignty and push the country into a debt trap.

5 Foreign technology is by and large capital intensive. It's impact is inconsistent with large manpower resources in the country. The New Industrial Policy has overlooked hardships of workers. Who are likely to be adversely affected and no social security mechanism has been created to mitigate it.

Check Your Progress A

1 State the objectives of the Industrial Policy of 1956.

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2 State the three industries now reserved for public sector.

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3 What is the main aim of putting all industries under automatic route for foreign direct investments.

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4 State which of the following statements is true or false.

(a) Liberalisation and privatization approach required significant changes in industrial and monetary policies.

(b) Under Industrial Policy Resolution 1956, all industries not forming part of Schedule A were left for the private sector.

(c) The capacity of large scale industries to generate employment opportunities is far more than small scale and cottage industries.

(d) The scheme of broad branding, introduced in 1984, changed their product mix in according with changes in demand patterns without procedural hassles.

(f) The phased manufacturing programme to increase the pace of indegenisation of manufacturing was introduced by 1991 Industrial Policy.

15.3 FISCAL POLICY

Fiscal policy refers to the policy of the government with regard to taxation, pubic expenditure and public borrowing with specific objectives in view. While the developed countries attempt to achieve economic stability through fiscal policy, the goal of developing countries is to achieve economic growth with social justice.

15.3.1 Objectives of Fiscal Policy

India is presently a developing economy. Its social system is inegalitarian on account of economic disparities and widespread poverty. Practising indicative economic planning, India had greatly relied on fiscal policy until the liberalisation process began. The Planning Commission had stated in Seventh Five Year plan, "Through it (fiscal policy) the government creates and sustains the public economy consisting of the provision of public services and public investment, at the same time it is an instrument for reallocation of resources according to national priorities, redistribution, promotion of private savings and investments and maintenances of stability". Thus, the fiscal policy has a multi-dimensional role. In particular, it aims at (1) improving the growth performance of the economy, and (2) ensuring social justice to the people.

Improving growth performance : The fiscal policy improves growth performance of an economy in two ways : (a) by improving the resource mobilization, and (b) by influencing the efficiency of resource allocation

(a) *Mobilisation of resources for developmental purposes :* During the five decades of economic planning, India's tax effort has been lacklusture. In 1950-51 when the First Five Year Plan commenced, the tax GDP ratio was rather low at 6 per cent. Since then, it rose at a modest rate for four decades and stood at 15.7 per cent in 1991-92. During the 1990s, India implemented neo-liberal tax reforms as a result of which the tax GDP ratio declined to 13.4 per cent in 1998-99. Thereafter, there has been a modest increase in tax GDP ratio. In 2001-02, it was 14.5 per cent. In an economy where GDP has registered a growth rate of 4.27 per cent per annum and income is highly concentrated in the hands of 10 per cent of the population, this record in immobilising the revenue is rather disappointing. Besides tax revenue, other aspects of resource mobilisation are : generation of non-tax revenue, surplus of public sector enterprises, and restricting revenue expenditure of the government.

    Somehow, the government has failed completely in mobolising adequate resources for development purposes. Rate of public savings GDP ratio is considered to be a good index of resource mobilisation effort. In 1980-81, the public saving GDP ratio was 3.4 per cent which is too low. During 1990s, there has been a steep fall in public savings and since 1998-99 public saving GDP ratio has been negative. However, the glaring failure of the fiscal policy has been that it did little to prevent the growth of black income.

(b) *Allocational efficiency :* Fiscal policy improves growth performance of an economy through its effect on efficiency of resource allocation. In India, out of all indirect taxes, customs duties have often adversely affected the allocational efficiency. Since the rates of import duties were high until tax reforms were implemented in this country, certain industries got unnecessary protection which led to sub-optimal allocation of resources. Similarly, subsidies on non-merit goods caused distortions in allocation of resources. In both cases, allocational efficiency having fallen affected growth performance of the economy adversely. In India, gigantic size of black economy exits. This blunts the allocation signals of the tax system. It is now well confirmed that decisions of corporates in respect of production are very much influenced by the possibilities of tax avoidance through legal and illegal methods. The black economy also vitiates the allocative aspect of the fiscal policy on the expenditure side.

Ensuring social justice : There are extreme inequalities in income and wealth in India. While the vast mass of population suffers deprivation, a small number of people possess huge financial resources and other assets. In an egalitarian society such inequalities are not to be allowed. The fiscal policy can do a lot to reduce these inequalities. For example, the tax structure can be made progressive. As far as public expenditure is concerned, the government can undertake poverty alleviation programmes, provide free education and subsidized medical care for the poor. Thus, by a judicious mix of tax policies and public expenditure polices, the government can help in reducing income inequalities.

In India, the fiscal policy is expected to conform to the principle of equity and, therefore, the tax structure should be progressive in nature. There is no denying the fact that, in terms of nominal rates, the direct taxes in India are progressive. But, there exits a large amount of undisclosed income in the hands of industrialists, traders, builders, professionals, bureaucrats and politicians on which no tax is paid. Hence, the progressivity in rates of income tax has hardly been effective in practice. As for the public expenditure, poor people have not benefited much form it. Thus, in totality, the fiscal policy in India does little to ensure social justice and, with the ascendancy of neo-liberal ideology, it is no longer an instrument of social justice.

15.3.2 Long Term Fiscal Policy (1985-90)

In India, the Government followed an adhocist approach in formulating fiscal policy until the mid-eighties. Hence, most of the time, the fiscal policy did not have any direction and was inconsistent with the proclaimed objectives of economic planning. During eighties, however, the Government decided to formulate a long term fiscal policy for a period of five years. Accordingly, the Long Term Fiscal Policy co-terminus with the Seventh Five Year Plan was announced on December 19, 1985. The main objectives of the Long Term Fiscal Policy (1985-90) were same as those of the Seventh Plan, and it had been suggested that the fiscal policy should aim at keeping inflationary pressure under control. This implied that for the financing of plans greater reliance should placed on surpluses generated by the budget and public sector undertakings rather than on public borrowings

The financial framework : The Seventh Plan pattern of financing provided the financial framework for the long term fiscal policy, 1985. Resources amounting to 10.1 per cent of the GDP were to be deployed by the Central Government for the Central component of the Seventh Five Year Plan. While domestic borrowings and net external finance were expected to provide resources for the Seventh Plan almost at the same level as under the Sixth Plan, the relative role of public savings was envisaged to be greater in the Seventh Plan. The public sector undertakings were required to contribute 2.9 per cent of GDP in1985-86. Their contribution was to increase overtime and was envisaged to be 4.1 per cent of GDP in 1989-90. However, the public sector contribute 2.9 per cent of GDP in1985-86. Their contribution was to increase overtime and was envisaged to be 4.1 per cent of GDP in 1989-90. However, the public sector undertakings failed to generate the expected resources. Similarly, the Central Government balance from current revenue was expected to be negligible while in practice it consistently remained negative. In the terminal year of the Seventh Plan it was as large as (-) 2.6 per cent of GDP. The aggregate tax revenue proceeds during the Seventh Plan period were along the expected lines. However, direct tax revenue proceeds did not meet the target. In contrast, indirect taxes performed better and exceeded the Seventh Plan projection. Non-tax revenues also exceeded the targets consistently.

During the Seventh Plan, the most glaring failure was in respect of the non-plan revenue expenditure. Throughout the Seventh Plan period, non-plan revenue expenditures consistently exceeded the projections mainly due to interest payments, food and fertilizer subsides and defense expenditures. This factor caused a major fiscal crises during the late eighties. The revenue deficit of the Central Government was as high as 2.7 per cent of GDP in 1988-89 and 2.6 per cent of GDP in 1989-90. The gross fiscal deficit also exceeded 6 per cent of GDP in these years.

In view of the fact that for financing the Seventh Plan, the domestic borrowings were to be kept within fiscally manageable limits, the Central Governments' public savings had to consistently increase. This required two pronged effort. First, the revenue raising capacity of the tax system had to be raised, which required structural reforms in the tax system whereby revenues go up automatically as incomes and prices rise. Second, growth of non-plan public expenditure, particularly on defense, interest payments and subsidies had to be kept within limits. The Government, however, failed on both fronts. This led to greater dependence on domestic borrowings. In 1989-90, for example, the domestic borrowings amounted to 7.8 per cent of GDP as against projected 4.4 per cent.

The tax structure : India's tax structure has always been characterised by the predominance of indirect taxes. The proportion of indirect taxes steadily rose from71 per cent of the total tax revenues in 1960-61 to 78 per cent in 1970-71 and further to 85 per cent in 1985-86. The low proceeds from direct taxes in total tax revenue reflected the unsatisfactory nature of India's tax structure. The long Term Fiscal Policy of 1985 had, therefore, asserted that there was a strong need to raise revenue yield of income tax and corporation tax. In order to meet shortage of resources, the Government in the past had often raised customs duties. This caused distortions in allocation of resources. However, the Long Term Fiscal Policy put a note of caution that, while levying customs duties, their long run effects on efficiency and resource allocation must not be overlooked.

The Budget for 1985-86 initiated the process of tax reforms. It lowered the rates of personal income tax so also the corporation tax, and abolished the investment allowances. However, the tax system remained complex and left immense scope for tax evasion.

The Long Term Fiscal Policy of 1985 had also made important proposals for reforms in customs and excise duties, the two main indirect taxes levied by the Central Government. Customs duties presented a complex situation. While yielding good revenue, they provided unwarranted protection to certain industries which distorted resource allocation. Excise duties were also quite high and discretionary. There was lack of transparency and their incidence was much more on the buyers than what the proposed reforms in the structure of customs and excise duties are designed to promote the primacy of the basic objectives of economic growth, equity, simplicity and build in revenue raising capacity. In addition, these reforms are intended to serve as vehicles for progressively moving from discretionary, quantitative redirections and physical controls to fiscal instruments in managing the economy".

Critical appraisal : Announcement of the Long Term Fiscal Policy of 1985 eliminated uncertainty in the realm of fiscal management. It favoured a significant reduction in domestic borrowing to correct fiscal imbalance and provided a framework for restructuring direct taxes. However, it was felt that on equity considerations this framework lacked merit. Not only that, the suggestion to reduce rates did not evoke favourable response from all quarters as it undermined progressivity of the tax structure. The expectation that it would induce better compliance was belied. The Long Term Fiscal Policy of 1985 made no proposals for eliminating inter sectoral equity that existed in the economy due to exemption of agricultural incomes from personal income tax. It was expected that the public sector enterprises would generate large resources through rationalisation of pricing policy, better capacity utilisation, improved productivity levels and drawing down of inventories. But, they failed to generate the expected resources.

The biggest weakness of the long term fiscal policy, however, had been its lack of concern for deepening fiscal crisis. Although the policy took note of the growing fiscal imbalances, it did not suggest appropriate measures to deal with the emerging fiscal crisis in a forthright manner. The policy prescriptions were by and large impractical and were thus doomed to fail.

15.3.3 Fiscal Imbalance and The Current Fiscal Approach

Non-development expenditure registered a steep rise in the 1980s and, consequently, the fiscal situation kept on deteriorating throughout the decade. By the beginning of 1991-92 there was severe fiscal imbalance which indicated that the fiscal crisis was deepening. The two commonly used indicators of fiscal imbalance are the revenue deficit and the gross fiscal deficit. The revenue deficit is the conventional indicator and shows the amount by which revenue expenditure exceeds the revenue receipts. It does not measure the total structural imbalance in fiscal operations of the government and therefore does not appropriately show the resource gap. In contrast, the gross the fiscal deficit is a complete measure of fiscal imbalance which refers to excess of total expenditure over government revenues and grants. It thus reflects the total resource gap of the government. The concept of gross fiscal deficit is now used internationally to estimate the fiscal imbalance.

The 1990-91 fiscal imbalance : In 1990-91, when liberalisation polices were initiated in India there were alarmingly high fiscal imbalances in the budgets of both the central and the state governments. The revenue deficit of the Central Government was as high as 3.3 per cent of GDP in 1990-91 as against 1.5 per cent of GDP in 1980-81. In contrast, the position of state governments was not bad. Nonetheless, the revenue deficit of the state governments was 0.93 per cent of GDP in 1990-91 as against a revenue surplus of 1.03 per cent of GDP in 1980-81. In terms of gross fiscal deficit, fiscal imbalances of both the central and the state governments needed immediate remedial measures. In 1990-91, the combined fiscal deficit of the central and the state governments was as high as 9.9 per cent of GDP of which the Center's fiscal deficit alone was 6.6 per cent of GDP.

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In 1990-91, interest payments of the Central Government were as large as 29 per cent of its revenue expenditure. How alarming this situation was can be understood from the fact that interest payments had exhausted 39.1 per cent the total revenue receipts of the Central Government. If corrective measures were not initiated immediately the situation could deteriorate further and the government could easily be caught in a debt trap. Apart from interest payments, expenditure on defense and food and fertilizer subsidies led to an unchecked growth of non-plan revenue expenditure which in fact has been the main cause of present fiscal malaise. Lately, the Central Government has pursued a populist policy to appease powerful lobbies. This approach has prevented it from cutting down non-plan revenue expenditure. The existing fiscal situation is non-sustainable. In 2001-02, while the revenue deficit was as large as 4.2 per cent of GDP, the gross fiscal deficit was also quite large at 5.9 per cent of GDP. The expected decline in fiscal deficit in 2002-03 did not materialize and it remained stuck at 5.9 per cent of GDP.

Fiscal correction : During the 1990s the Central Government, despite its commitment to restore the fiscal balance by reducing its fiscal deficit, did not achieve anything significant. Since the fiscal deficit of the Central Government was unsustainable at 6.6 per cent of GDP in 1990-91, it was envisaged to reduce it to 4.8 per cent in 1991-92. The burden of this correction fell primarily on expenditure control. The Government resorted to some drastic measures to reduce the fiscal deficit. After the 1991-92 budget had been passed, the Government imposed a 5 per cent cut on the expenditure provisions contained in the budget. This was an unpopular move but showed results as the fiscal deficit declined to 4.7 per cent. The 1992-93 budget shows a fiscal deficit of 4.1 per cent of GDP. However, lack of resolve to further lower down the fiscal deficit and laxity in fiscal operations resulted in fiscal deficit of the order of 4.8 per cent of GDP.

In 1993-94, the fiscal deficit once again rose to unsustainable level of 6.4 per cent GDP. The budget for 1993-94 had proposed fiscal deficit of just 4.1 per cent of GDP as lowering down of fiscal deficit to this level was necessary to control inflationary pressures and reduce current account deficit to a sustainable level. Subsequently, the fiscal deficit of the Central Government steadily declined for three years. In 1996-97, it was 4.1 per cent of GDP.

In the late 1990s, the rate of increase in tax revenue declined on account of sharp reduction in tax rates. In fact, while implementing the recommendation of the Chelliah Committee to reduce tax rates at all levels, the government had hoped that tax revenue would increase in accordance with the Laffer effect. But, somehow, these expectations remained unfulfilled and the fiscal deficit began increasing. In 1997-98, it was 4.8 per cent of GDP which increased to 5.4 per cent of GDP in 1999-2000, to 5.6 per cent of GDP in 2000-01, to 5.6 per cent of GDP in 2000-01, and further to 5.9 per cent of GDP in 2001-02. It remained stuck at 5.9 per cent of GDP in 2002-03. Of course, it was also the result of excessive public expenditure. For restoring the fiscal balance the following measures may be recommended :

1 **Reducing interest payments** : Interest payments have contributed most to fiscal imbalances in the finances of the Central Government. During the 1990s, despite the awareness that interest payment must be reduced for restoring fiscal balance, it continued to increase. Increasing from Rs. 24,955 crore in 1991-92 to Rs. 59,478 crore in 1996-97 and to Rs. 1,04,894 in 2001-02, interest payments of the Central

reduced by bringing down the gross interest payment or by increasing the income from the Government's investments. It does not seem feasible to increase the latter. It is, therefore, necessary to find ways of reducing the gross interest payments by the government".

2 **Restricting non-interest expenditure :** For restoring fiscal balance, the growth of non-interest expenditure has to be restricted. In some cases, reduction in expenditure is considered both desirable and feasible. Over the years, subsidies, capital assistance to inefficient public sector enterprises, and expenditure on administration and defense have increased. All these have contributed to increasing the fiscal deficit. There is now a strong case to cut down subsidies, particularly on fertilizers. The Government has already reduced budgetary support to public enterprises. For reducing expenditure on administration, the Government must get rid of surplus staff.

3 **Raising tax revenue :** In India, tax revenue can be raised by taxing the hitherto untaxed incomes. Moreover, the rampant tax evasions must also be checked. Attempts in these directions requires strong political will. It is heartening to note that the present government is quite pragmatic and, alongside keeping the tax rates within reasonable limits, it is also taking steps to improve conformity to tax laws.

15.3.4 The Current Fiscal Agenda of the Central Government

It may be noted that in the broad framework of neo-liberal economic polices, the Government at the Centre has set the following agenda for fiscal reforms :

1 Simplification of tax laws;

2 Low rates for direct taxes with improved administration and enforcement;

3 Creating predictable tax policy environment;

4 Greater recognition to resource allocation and efficiency in collection of taxes;

5 Pursuit of expenditure control; and

6 Greater reliance on non discretionary fiscal and financial instruments for managing the economy than on discretionary physical controls.

Check Your Progress B

1 What do you mean by fiscal policy ?

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2 How can fiscal policy reduce inequalities ?

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3 Distinguish between revenue deficit and fiscal deficit.

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4 Fill in the blanks

(a) During 1990s, India implemented neo-liberal tax reforms as a result of which the tax GDP ratio declined to __________ per cent 1998-99.

(b) India's tax structure has always been characterised by the predominance of ________________ taxes.

(c) Announcement of Long Term Fiscal Policy in India eliminated ___________ in the realm of fiscal management.

(d) In 1990-91, interest payment of the Central Government was 29 per cent of its _____________ expenditure.

(e) India's social system is inegalitarian on account of economic _____________ and widespread poverty.

(f) In 1990-91, when liberalisation policies were initiated in India, there were alarmingly high ________________ in the budgets of both the central and the state governments.

15.4 MONETARY POLICY

Harry G. Johnson, a leading American economists has defined monetary policy as a "policy employing the central bank control of the supply of money as an instrument for achieving the objectives of general economic policy". The monetary policy thus refers to a system of regulating the supply of money and control of the cost and availability of credit of the central bank of the country through the use of deliberate and discretionary action for achieving the objectives of general economic policy. Economists often make a distinction between monetary policy and credit policy. While the monetary policy is concerned with regulating the supply of money, the credit policy is concerned with managing the supply of credit. Thus, the domain of the credit policy is far more extensive than that of the monetary policy. Nonetheless, there are some points of commonality in the two policies.

1 The same authority, viz., the central bank administers both types of policies.

2 The instruments of controlling both money supply and supply of credit at the aggregate level are the same.

3 The same forces determine the supply of money and the supply of credit.

Because of the these points of commonality, economists usually use the concept of monetary policy, as inclusive of credit policy.

15.4.1 Objectives of Monetary Policy

The main objectives of monetary policy are :

1 Price stability;

2 Healthy balance in balance of payments;

3 Full employment and maximum feasible output; and

4 High rate of economic growth.

Price Stability : The main objective of monetary policy was considered to be the price stability until the 1930s. The belief among most of the economists was that mild manipulations in the supply of money by the central bank could avert both inflation and severe depression. In fact, the monetary policy was fully depended upon to ensure price stability. However, the crash of prices during the Great Depression, the World War II and in the post war period shattered the faith in effectiveness of the monetary policy to ensure price stability. All the same, in the recent decades once again, the neoclassical economists have been emphasising price stability as an important objective of monetary policy. Their contention is that price stability is necessary for orderly production behaviour and general price stability. It is being argued that price stability ensures both economic growth and full employment and promotes trade and commerce which is considered a **sine qua non** of economic prosperity.

It may be noted that price stability does not imply constant price level. Economists of neo-classical school consider slowly rising price level very much consistent with the concept of price stability and conducive for increased productive activity.

Healthy balance in balance of payments : In classical economic discussion, exchange rate stability was regarded as an important objective of monetary policy. Since free trade was considered to be an engine of economic growth, the importance of exchange rate stability was duly emphasised. Fluctuations in exchange rate were mild due to prevalence of gold standard. With the breakdown of gold standard in the 1930s, the situation changed. However, the Bretton Woods system that was created in the mid-forties once again restored the stability in the rate of exchange. But, this system collapsed in 1971 and with it the period of stable exchange rates once again came to an end. Hence, over the past three decades, we have been living in a regime of flexible exchange rates. The objective of exchange stability has lost its primacy and so it is now being considered of only secondary importance.

These days, most of the countries attempt to maintain a reasonable balance in balance of payments, and the adjustments in rate of exchange are gradually made through the intervention of the government in order to correct the disequilibrium in balance of payments. In modern times, the monetary policy is directed against investment activity in countries having deficits in their balance of payments. Any monetary measure that curtails investment leads to a reduction in income through its multiplier effects. A decrease is national income causes a fall in imports which eliminates some deficit in the balance of payments of the country in question. Similarly, the monetary measures which induce savings and curtail consumption have a favourable effect on balance of payments. Thus, from exchange rate stability, the focus has now shifted to healthy balance in balance of payments.

Full employment and maximum feasible output : During the days of the great depression in the 1930s when unemployment was enormous and widespread, it became quite evident that, left to itself, the economic system could not attain full employment levels. Keynes had argued that the objectives of full employment could be realised by increasing the effective demand through the state's intervention in the form of massive programmes of public investment. Since the revitalisation of monetary policy in recent decades, it is being suggested that soft interest rate policy encourages private investment which in turn raises the volume of output and employment. In developed countries, the emphasis is on overall economic stability. Full employment and maximum feasible output are obviously considered necessary for realising economic stability. The present day monetary policy aiming at full employment and maximum feasible output hopes to automatically ensure economic stability.

High rate of growth : After the World War II, during the latter half of the twentieth century when former colonies of European countries won freedom, an earnest desire was seen in these underdeveloped countries to initiate the process of growth and develop rapidly. Accordingly, government economic policies in these less developed countries aimed at achieving high rate of growth. Monetary policy has also been formulated to assist in accomplishing this objective.

The monetary policy in less developed countries generally allows money supply to exceed the demand for money by a small amount so that there is some increase in prices which is considered conducive to economic growth. Such a policy is expected to induce economic growth with many favourable effects on the economy. These are : (1) the small increase in price provides an incentive to private entrepreneurs to invest; (2) since there is unemployment and underemployment of resources in these countries, additional money supply creates demand for their utilisation; (3) with continuous structural changes accompanied by economic growth, demand for liquid assets increases and so does the supply of money. However, the policy of pushing up money supply ahead of demand is to be pursued continuously, because there is always a danger of inflationary pressures in the economy getting out of control.

The experience over the decades has shown that these objectives of monetary policy are often in conflict and thus cannot be realised simultaneously. Hence, the monetary authorities attempt to frame a policy of "long-run price stability at maximum feasible output". This is often referred as the policy of 'long-run neutral money.

15.4.2 Pre 1990-91 Monetary Policy

The Reserve Bank's monetary policy during the pre-reform period since the beginning of economic planning in early fifties was designed to meet the particular requirements of India's developing economy. Aptly summarising the Reserve Bank's monetary policy in this phase, S. L. N. Simha had stated, "The RBI's responsibility is not merely one of credit restriction. In a growing economy there has to be a continuous expansion of money supply and bank credit, and the central bank has the duty to see that legitimate credit requirements are met. The bank's responsibility in the circumstances is mainly to moderate the expansion of credit and money supply in such a way as to ensure the legitimate requirement of industry and trade and curb the use of credit for unproductive and speculative purposes. That is why the Bank has rightly called its credit policy in recent years as one of controlled expansion".

The Reserve Bank enjoys extensive power to control the supply of money and credit. It has all the quantitative methods of credit control, viz., bank rate policy, open market operations, cash reserve ratio (CRR) and statutory liquidity ratio (SLR) in its arsenal. It has also been empowered to use selective credit controls under the Banking Regulation Act, 1949. We shall now explain how effectively the Reserve Bank had employed these instruments of credit and monetary control during the four decades from 1950-51 to 1990-91, the pre-liberalisation period. In this period, the monetary policy of the Reserve Bank was formulated keeping the objectives of economic planning in view.

Economic planning in a country like ours usually leads to an expansionary fiscal policy on account of increasing demand to expand both plan and non-plan expenditure. Monetary policy, under these circumstances, often operated to accomplish the conflicting objectives. On the one hand, it was expected to assist in realising the basic objectives of planning, while on the other, it was required to combat inflationary pressures which developed on account of plan financing.

RBI's anti-inflationary policy : The era of economic planning in this country ushered in the early fifties when in the wake of the commodity boom generated by the Korean war inflationary pressures had built up. The Reserve Bank in this period pursued a moderately restrictive monetary policy and raised the bank rate from 3 per cent to 3.5 per cent in November 1951. The annual rate of increase in M_3 (M_1 and time deposits with banks) during the first half of the 1950s was at 3.4 per cent.

The strategy of growth adopted in the Second Plan generated inflationary pressures. Hence, the Reserve Bank was given power to vary cash reserve ratio of the commercial banks in 1956. The selective credit control scheme was introduced in May 1956 to control speculative hoardings of essential agricultural commodities. The bank rate was raised to 4 per cent in May 1957. These measures restrained growth of credit to the commercial sector. But, the annual increase in M_3 was as large as 8.2 per cent which led to 6.3 per cent per annum increase in wholesale prices. During the Third Plan period, M_3 increased at the rate 9.1 per cent per annum resulting in an annual 5.8 per cent rate of inflation. Taking note of these inflationary pressures in the economy, the Reserve Bank pursued a contractionary monetary policy. The bank rate was thus raised to 4.5 per cent in January 1963, to 5 per cent in October 1964 and further to 6 per cent in March 1965. Among other measures, raising of the SLR in September from 20 per cent to 25 per cent was most important. The Reserve Bank also introduced the Credit Authorisation Scheme in 1965 for regulating large lendings to relatively big borrowers. These measures failed to contain the inflationary pressures largely on account of failures on the supply front.

During the Fourth Plan period, M_3 increased at an annual rate of 16.2 per cent. This generated tremendous inflationary pressures and the Reserve Bank used various techniques of monetary control to keep inflation under check. The SLR was raised from 26.0 per cent to 32.0 per cent in phases. The CRR was also raised from 3.0 per cent to 7.0 per cent to contain liquidity, and the bank rate was raised to 6 per cent on January 9, 1971 and to 7.0 per cent on March 31, 1973. The impact of these measures however got diluted by increase in refinance facilities, and the wholesale prices rose by 12.3 per cent in 1972-73 and 20.2 per cent in 1973-74. In 1974-75 the inflation rate in terms of wholesale prices was record high at 25.2 per cent. For dealing with this situation, the bank rate was raised from 7 per cent to 9 per cent on July 24, 1974. The SLR was also raised from 32 per cent to 33 per cent on July 1, 1974. However, for dealing with such inflationary situation, the monetary policy actions alone were not enough. Hence, a number of fiscal measures were also undertaken to check the spiraling inflation. These measures had the desired effect and the inflation was brought under control. In 1979-90, however, India faced one of the worst droughts and the output fell by 6.0 per cent. In such a situation, the monetary measures were found inadequate to meet the challenge and the wholesale prices rose by 17.1 per cent.

During the Sixth Plan period, M_3 increased at the annual rate of 16.9 per cent and the price level rose at the rate of 9.3 per cent per annum. The monetary measures had failed to keep inflationary pressure under control. On July 12, 1981 the bank rate was raised from 9 per cent to 10 per cent, CRR from 6.0 per cent to 9.0 per cent during the first half of the eighties, and SLR to 36 per cent in the last year of the Sixth Plan. However, the inflation did not abate. The price situation in the latter half of the eighties called for great caution due to 17.4 per cent per annum increase in M_3. Expansion of supply of money at this scale was bound to be inflationary. The Reserve Bank tried to combat the inflationary pressure by not only raising the CRR from 9 per cent to 15 per cent over a period of five years, but also the SLR from 36 per cent to 38.0 per cent. Apart from applying these quantitative methods of monetary control, refinance facilities were also drastically curtailed by the Reserve Bank. However, inflationary pressure persisted and the price level rose by 12.1 per cent in 1990-91.

15.4.3 Post 1990-91 Monetary Policy

In India, the monetary policy framework significantly changed during the 1990s. Under the influence of monetarist approach and the retreat of the state, monetary policy emerged as the principal instrument of macro economic stabilisation and structural reforms in the financial system. However, the objective of economic policies during the liberalisation phase of the 1990s has merely been ensuring price stability and growth. Hence, the concern of the monetary policy has also been to create a competitive environment in the financial sector and ensure sufficient credit for the private sector at low cost. In fact, India's central bankers never favoured absolute price stability. They broadly agreed with the suggestion of the Chakaravarty Committee (1985) that in Indian conditions 4 per cent rise in the general price level should be acceptable as it was necessary to attract resources to growth sectors.

Operating Procedures of Monetary Policy : During nineties, driven by the need for a market oriented policy mix of open market operations and interest rate signals, the operating procedure of monetary policy changed dramatically. The Reserve Bank introduced open market operations in an attempt to move from direct to indirect instruments of monetary control. Following the recommendations of the Committee on the Financial System (Narasimham Committee), CRR and SLR have been lowered in a phased manner. The SLR on total outstanding net demand and time liabilities (NDTL) has been brought down from 38.5 per cent to 25 per cent, and the CRR which is a direct and fairly effective instrument of monetary control is no longer is use. However, over the years the CRR has been brought down from 15 per cent of NDTL to 4.5 per cent. The Reserve Bank wants to reduce it ultimately to the statutory minimum of 3.0 per cent.

In pursuit of the recommendations of the Committee on Banking Sector Reforms (1988), an Interim Liquidity Adjustment Facility was introduced in April, 1999. This later transited into a full fledged liquidity adjustment facility. The Reserve Bank now manages liquidity through open market (including repo) operations. Another major step towards a market based monetary policy has been the reactivation of bank rate. The bank rate which was raised to 12 per cent on October 8, 1991, has now been brought down to 6.0 per cent in a phased manner.

Augmenting liquidity through lowering of SLR and CRR and open market operations and lowering of rates of interest by constantly bringing down the bank rate have been the main methods of monetary management during the nineties. Implementation of these policy measures during liberalisation phase clearly suggest that the entire concern of the monetary policy during the nineties has been to ensure adequate expansion of credit at low cost so as to assist the industrial growth. In India, the existing industrial slow down is demand constrained. However, the policy makers, caught in the ideological framework of monetarism, continue to attempt supply side measures without success.

Critical Appraisal : The decade of 1990s began with a severe balance of payments crisis and a high rate of inflation which reflected serious macro economic imbalances. The Reserve Bank's response to this challenge was swift as it introduced monetary and credit measures aimed at import compression and demand containment. These initial stabilisation efforts were successful. However, the Reserve Bank had to face a fresh challenge resulting from capital flows. It tackled the problem by adopting a policy which stabilized the monetary impact of these capital flows and maintained the export competitiveness of the economy. These two purposes were achieved by the Reserve Bank by absorbing surplus capital flows in its balance sheet. For greater clarity we shall now appraise the monetary policy of the Reserve Bank since 1990-91 under the following three heads :

1 Inflation record

2 Analytics of bank credit

3 Interest rate pass-through

1 **Inflation record :** The pursuit of price stability has been central to neo-liberal reforms initiated in the 1990s. Inflation has never been targeted in India. But monetary policy is said to be aimed at curbing inflationary pressures. In the early part of the 1990, the inflation rate fluctuated around 8-9 per cent per annum. Since then, it has scaled down to 4-5 per cent per annum. During the eleven years period from April, 1991 to March 31, 2002, quality of M_3 expanded at the rate of 17.7 per cent per annum. This rate of monetary expansion has been inconsistent with price stability. Yet in 2002-03 the supply of money was expanded by 15.5 per cent while the GDP growth was 4.4 per cent. In this year, despite modest industrial growth, bank credit to corporate sector expanded substantially. This approach obviously reflects lack of seriousness the part of the monetary authority to keep inflation under control because, to achieve a low rate of inflation, firm control of the rate of monetary expansion is necessary.

2 **Analytics of bank credit :** Apart from pursuing the objective of price stability, the Reserve Bank tries to ensure that sufficient credit is available at low cost with the hope that it will lead to industrial growth. At the heart of steep reduction in both CRR and SLR also, the objective is to enhance lendable funds with the banking system. In the latter half of the 1990s, however, and the Indian economy slowed down and the Reserve Bank has been forcing a continuous decline in interest rates with the purpose of reviving credit demand and increase in investment activity.

3 **Interest rate pass-through :** The effectiveness of the signals emanating from the changes in the policy rates (bank rate and the repo rate) is the degree of pass-through, that is, the speed and magnitude of the market interest rate spectrum to monetary policy signals. Between March 1998 and February 2003, the bank rate, the repo rate and the CRR were substantially lowered down. This easing of monetary policy stance was reflected in a general softening of interest rates in the money markets. However, prime lending rates of major banks remained sticky. This indicates a low level of pass-through of changes in the policy rates on the lending rates, thereby blunting the efficacy of the monetary policy.

During the 1990s, an attempt has been made to assign a critical role to monetary policy for economic management. It is, however, felt that the monetary policy has a limited role in Indian context. Partha Sen opines, "Monetary policy in India is functioning in an environment where it can be expected to deliver very little, if anything at all. At the best of times the monetary policy can ensure a smooth functioning of an economy if a number of pre-conditions are met. Put differently, monetary policy in India can do a lot of damage but its ability to single handedly do good is limited".

Check Your Progress C

1 Define monetary policy.

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2 Why do economists treat the concept of monetary policy as inclusive of credit policy?

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3 What are the various methods used by Reserve Bank of India to control the supply of money and credit ?

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15.5 LET US SUM UP

The Indian economy has literally stagnated during the pre-independence period. It was essentially agrarian in character with little development of basic and capital goods industries. The government took these objective realities into consideration while framing its economic policies after independence. Of these, the industrial policy, fiscal policy and monetary policy are considered very important for the business.

The first industrial policy was issued by the government of India immediately after independence in April, 1948 which had contemplated a mixed economy and accepted the importance of small and cottage industries in creation of employment. It was followed by the Industrial Policy Resolution of 1956 which defined the framework for industrial development in the earlier planning period and aimed at accelerating industrial growth by according overriding priority to heavy and capital goods industries. Industries of strategic importance were to be developed in the public sector. Though the 1956 Resolution emphasised rapid industrial development, it did not favour the growth of monopolies and concentration of economic resources.and power.

During the 1970s, despite government's allegiance to the 1956 Industrial Policy Resolution, significant departures were made from its basic approach. Besides accepting a proposal for setting up the joint sector, several concessions were given to domestic private sector units and foreign MNCs. Similarly, during 1980s, the industrial policy was drastically changed and the following steps were taken to liberalise it such as (1) raising limit of exemption from licensing; (2) delicensing; (3) relaxations to

MRTP and FERA companies; (4) capacity endorsement; (5) broad branding of industries; (6) determining minimum scales of operation; (7) incentives for export promotion; and (8) enhancement of investment limit for small scale industries.

The New Industrial Policy of 1991 deregulated the industrial economy in a big way. Its salient features are : (1) Abolition of industrial licensing; (2) Dilution of public sector's role; (3) Scrapping the threshold limit of assets in respect of MRTP undertakings; (4) Free and liberal entry to foreign investment and technology, (5) Liberalisation of industrial location policy, (6) Abolition of phased manufacturing programmes for new projects; and (7) Removal of mandatory convertibility clause. The new industrial policy has failed to accelerate industrial development. On the contrary, since 1991 the rate of industrial growth has been both slow and erratic and significant distortions have cropped up in the industrial sector.

Fiscal policy refers to the policy of the government as regards taxation, public borrowing and public expenditure. Main objectives of fiscal policy are : (1) Improving growth performance; and (2 Ensuring equity and social justice. The fiscal policy improves growth performance of an economy in two ways, (a) by improving the resource mobilisation, and (b) by influencing efficiency of resource allocation.

In India, a long term fiscal policy was first announced in 1985. It was co-terminus with the Seventh Five Year Plan and its objectives were the same as those of the Seventh Plan. The financial framework for the long term fiscal policy 1985 was also provided by the pattern of financing of the Seventh Plan. Resources amounting to 10.1 per cent of GDP were to be deployed by the Central Government for the central component of the plan. During the Seventh Plan period, while tax revenue proceeds were along the expected lines, the public sector undertakings failed to generate the expected resources. The domestic borrowings were to be kept within fiscally manageable limits but, on account of growing non-plan public expenditure, the borrowings were larger than contemplated. During the latter half of the 1980s, failures on fiscal front led to deepening of the fiscal crisis.

India's tax structure has always been characterised by predominance of indirect taxes. Its share in total tax was as high as 85 per cent in 1985-86. Hence, there was strong need for raising revenue from income tax and corporation tax. The budget of 1985-86 lowered their rates and abolished the investment allowance. But these steps proved of little help. The Long Term fiscal Policy also proposed some reforms in custom duties and excise, and favoured gradual switch over to MODVAT.

In 1990-91, when liberalisation policies were initiated in India, the revenue and fiscal deficits of the Central Government were alarmingly high. The revenue deficit was 3.3 per cent of GDP while fiscal deficit was as high as 6.6 per cent of GDP. Even as late as 2001-02, the fiscal situation was unsustainable, the revenue deficit of the Central Government was 4.2 per cent of GPD while fiscal deficit was as large as 5.9 per cent of GDP. Thus, despite its commitment to restore fiscal balance, the Central Government failed to achieve anything significant. For restoring fiscal balance it must reduce its interest payments, restrict non-interest expenditure and raise tax revenue.

Monetary policy refers to central bank's policy to regulate supply of money and credit for achieving the objectives of general economic policy. The main objectives of monetary policy are : (1) price stability; (2) healthy balance in balance of payments; (3) full employment and maximum feasible output; and (4) high rate of economic growth.

The Reserve Bank's monetary policy during the four decades of economic planning until 1990-91 can be characeterised as the policy of controlled monetary expansion. The Reserve Bank in this period attempted to meet legitimate credit and money requirements of the economy. The Bank, however, enjoys extensive power to control money supply and credit. It has the power to use bank rate policy, open market operations, CRR, SLR and selective credit controls to regulate supply of money and credit. Throughout the pre 1990-91 period, the Reserve Bank attempted to combat inflation by using all the quantitative methods of credit control but, on account of reckless expansion of money supply (M_3), the inflationary situation prevailed.

During the 1990s, monetary policy emerged as the principal instrument of macro economic stabilisation. Operating procedures of the monetary policy changed in 1990s. SLR, CRR and Bank Rate were significantly lowered and reliance on open market operations increased. During the latter half of the 1990s, inflation scaled down to 4.5 per cent from 8-9 per cent in the earlier years of the 1990s. However, expansion in quantity of M_3 at the rate of 17.7 per cent per annum was dangerously high for maintaining the price stability. Reserve Bank has been forcing interest rates to fall in order to ensure cheap credit for reviving the credit demand and increase in the investment activity.

15.6 KEY WORDS

Allocational efficiency : It refers to the efficiency of productive resources allocation.

Bank Rate : The rate at which the Reserve Bank gives loans to the commercial banks against the security of government and other approved first class securities.

Broad Banding of Industries : When industries are grouped into broad categories, it is called broad banding of industries.

Cash Reserve Ratio (CRR) : Statutorily determined ratio of cash reserve against net demand and time liabilities of commercial banks.

Fiscal Deficit : It refers to the total resource gap of the government, viz., the excess of total government expenditure over government revenue and grants.

Fiscal Imbalance : It refers to a situation when the public revenues is not sufficient to meet the public expenditure.

Fiscal Policy : The policy of the government as regards, taxation, public expenditure and public borrowing with specific objectives in view.

M_3 : It refers to a broad concept of money supply which includes M_2 and time deposits with banks. It is also called 'broad money'.

Interest Rate Pass-through : It refers to the speed and magnitude of market interest rate spectrum to monetary policy signals emanating from the changes in bank rate and repo rate.

Monetary Policy : A regulatory policy whereby the central bank maintains control over supply of money for the realization of certain objectives.

Revenue Deficit : Revenue deficit refers to excess of revenue expenditure of the government over its revenue receipts.

Statutory Liquid Ratio (SLR) : Statutorily determined ratio of liquid assets to net demand and time liabilities of the commercial banks.

Selective Credit Control : The regulation of credit for specific purposes is termed as selective credit control.

15.7 ANSWERS TO CHECK YOUR PROGRESS

A 4 (a) True (b) False (c) False (d) True (e) True (f) False

B 4 (a) 13.4 (b) indirect (c) uncertainty (d) revenue (e) inequalities (f) fiscal imbalance

15.8 TERMINAL QUESTIONS

1 State the salient features of 1956 Industrial Policy Resolution. How far the objectives of this policy could be achieved.
2 Discuss the main features of the New Industrial Policy as enunciated by the Government of India in 1991. Attempt a critical appraisal of this policy.
3 Make attempt a critical appraisal of the pre 1991 industrial policy. What steps were taken to liberalise this industrial policy during 1980s ?
4 Distinguish between the New Industrial Policy of 1991 and the Industrial Policy of 1956.
5 "Fiscal policy has a multi- dimensional role." In the light of this statement, explain the objectives of the fiscal policy in India and state how far these objectives have been accomplished ?
6 Explain the fiscal imbalance that developed in India during the 1980s. State the current fiscal situation and discuss the measures to be adopted for restoring the fiscal balance.
7 Evaluate the Long term Fiscal Policy of 1985 in the light of objectives it was expected to achieve.
8 What do you mean by monetary policy ? Explain its main objective.
9 What are the techniques employed by Reserve Bank of India to control the supply of money and credit ? How effectively were they used during the four decade period from 1951 to 1991 ?
10 "In India, the monetary policy framework significantly changed during the 1990s". Elaborate on this statement and evaluate the monetary policy followed by the Reserve Bank of India during nineties.

Note : These questions will help you to understand the unit better. Try to write answers for them, but do not submit your answers to the university for assessment. These are for your practice only.