Unit 4 ❒ Economic Environment

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4.0 Introduction

Business enterprise is essentially an economic institution. It conducts its activities in the market system with the objective of profit maximization. The behaviour of an enterprise being economic in nature it is guided by business plans and targets thate are formulate taking into consideration the demand and supply conditions which are influenced by the economic envorionemnt. Howver, when we think about economic environment of business we commonly refer to the broad characteristics of the economic system in which the firm carries out its business activities. Thus, in the study of economic environment of business we generally put emphasis on the macroeconomic enviroenment that influences activities in a broad and geenral way.

In modern economy, there are broadly three sectors, namely, the business secotr, the household sector of individuals and the government. The basic economic activities are production and consumption. The business sector is concerned with production whilst the

other sectos are chiefly concerned with consumers. But in our times the government is also a part of the business sector in many counteis, including India. Among the 'others' the capital market and the external sector has profound influence on business. The busines sector being the most dynamic, is dependent upon all the three other sectors. In fact, all the sectors together condition the structure of the economy. However, all the activities that keep on going in these sectors create both jointly and separately the economic environment in which the business houses operate.

Independently, business houses can do little to change their economic environment. However, in countries where state control over the economy is not very rigid, the business firms can collectively do lots to make economic environment conducive to their activities. Business firms can organize their associations through which they can even influence the policy of governments.

4.1 Nature

The environment has its economic dimensions. The economic environment of busines is the economic atmosphere within which business operates, and which both influences and is influenced by the policies and modes of business, for the business environment relationship is a two-way traffic. The economic atmosphere is the result of the operation of innumerable economic variables, the major ones being : the economic policy of the home government, the economic policy of foreign governments with whom the home government has trade connections (through exports and imports), the budget with its pro or anti-busines stance reflected in its tax/subsidy policy, monetary policy (high or low interest), the movements of commodity and security prices, the attitudes and modes of labour unions, employment and income levels, availability of basic infrastructure (both financial and physical) and technology. Individual business units in any industry have practically no contorl over the above variables. But if the industry decides to work through their associations, they can influence government policy in a democratic country like India (e.g. strikes for realizing demands). Some economic forces, working from within business, create a kind of environment over which business units have some control. Thus, business is free to determine its organixation pattern, size of man power and output, product quality, internal control system and marketing mix. But in a welfare State this internal freedom is also considerably curtailed by various laws so that the profit-maximisation motive cannot override wider interests of consumers, workers, small shareholders and creditors.

4.2 Economic System

Each country has its own economic system. Economists define an economic system "as the sum total of the devices by which the preference among alternative purposes of economic activity is determined and by which individual activities are coordinated for the

achievement of these purposes. The central problem of economic system is the allocation of resources". These economic devices are not the same everywhere. They differ from country to country according to customs, traditions and socio-economic and politial compulsions.

The scope of private business and the extent of government regulation of economic activities depend to a large extent on the nature of the economic system, which is an important part of the business environment.However, without denying the existence of national differences we can classify the economic systems as socialism, capitalism and mixed economy. Socialism is a state where all resources other than labour are owned and used by the government along with labour for producing goods and services. The allocation of resources for producting these goods and services is made not by the market forces of demand and supply, but by a planning authority according to their estimate of demand for each good and availability of resources to satisfy that demand. Labourers get their rewards according to the principle of each according to his needs insetead of each according to his capacity (In the erstwhile USSR the economic systems was very much like this.) More resources are allocated for most useful and less resources for less useful products.

Capitalism, in the true sense, is a system of private property in both consumer and producer goods, freedom of enterprise, freedom of choice of occupation, and purchase in a free market, with very limited or no government intervention in economic activities. In capitalist economies the three central problems of the economy, namely, what to produce, how to produce and for whom to produce are solved by the operation of free market forces of demand and supply. In other words, the operation of the foreces of demand and supply solve the problem of allocation of resources and distribution of goods. Such an economy is therefore natrually characterized by inequality of income and wealth.

In between the two there is a system, called the mixed economy, where the market operates but considerably under State surveillance, so that weaker sections do not suffer, and where some businesses are State-owned, some are privately owned and the rest are owned jointly by the State and private enterprise (as for instance in India).

Those countries that were poor but wanted to avoid rigors of state control and provide private entrepreneus a role to play in the production of goods and services for overall development, with economic and social justice to every citizen, adopted the mixed economic systems. In mixed economies the governments discharge the role of planner and keep in its hand the basic and strategic industries. In mixed economies the government functions as the mediator between the conflicting economic groups as well as the consumers of end products.

However, in today's world none of the extremes, capitalism and socialism can be found. The laissez-fare capitalism of Adam Smith's visulization had to be adjusted to be compatible with ground reality; that is possibility of revolution of the poor, particularly the rorking class. Thus, since the beginning of the last century and particularly since the Great

Depression of USA and after the World War II came adjustments in the capitalist system through the recognition of role of state in regulating the business activities for the better functioning of the economic system.

Similarly, adjustments also came to socialism with limited role for market mechanism in the allocation of resources for generating entrepreneurship, a basic requirement of economic development. In fact, in the socialist countries it was observed that after the standard of living of the people registered some improvement, people's initiative and seriousness for further economic progress started diminishing due to lack of sufficient incentives. Hence, these countries had to provide scope for operation of market forces for encouraging people to take initiative for achieving higher levels in economic development.

4.3 Industrial Policy of 1948

The industrial policy of a country reflects the direction and pattern of industrial development it desires to have to help release the economic, social and political inputs for national development by means of industrialization. In fact, the industrial development of a country is guided and fostered by the industrial policy of the government.

Immediately after attainment of independence, the government of India felt it nexessary to make clear its policy on industralization of the country. Accordingly, a Resolution on Industrial Policy was announced on April 6, 1948.

The Industrial Policy Resolution of 1948, which envisaged that "the State must play a progressively active role in the development of industries," established exclusive monopoly of the Central Government in the manufacture of arms and ammunitions; the production and control of atomic energy; and ownership and management of railway transport. The establishment of new undertakings in six other major industries (1) coal, (2) iron and steel, (3) aircraft manufacture, (4) ship-building, (5) manufacture of telephone, telegraph and wireless apparatus, excluding radio receiving sets, and (6) mineral oils was made the exclusive responsibility of the State. But, in the national interest the State itself can secure the cooperation of private enterpirses, subject to such control and regulation as it may deem fit. The rest of the industrial field was generally left open to private enterprise, individuals as well as cooperatives, but hte State retained the right to participate in any of these industries.

The Industrial policy Resolution of 1948, thus visualised a mixed economy and emphasized the participative, promotional, and regulatory roles of State in industrialization of India.

4.4 Industrial Policy of 1956

When the Industrial Policy Resolution of 1948 was announced, the Constitution of

India had not taken the final shape, the Planning Commission was not there and the First Five Year Plan was to come after three years. Moreover, "socialistic pattern of society" had not yet been officialy adopted as the national objective. As the Industrial Policy of 1948 could not foresee all these things, with the launching of the First Five Year Plan it become clear that the industrial policy of the government needed appropriate change for accommodating the new vision of the planners and policy makers. A new Industrial Policy Resolution was, therefore, announced on April 30, 1956 coinciding with the launching of the Second Five Year Plan from April 1956.

The Industrial Policy Resolution of 1956 was socialist oriented and widened the horizon of the public sector. In order to realize the aims specified in the Preamble to the Constitution of India and to give effect to the Directive Principles of State Policy as well as to achieve the objective of a socialistic pattern of society it was decided that "the State will progressively assume a predominant and direct responsibility for setting up new industrial undertakings and for developing transport facilities. It will also undertake State trading on an increasing scale. At the same time, as an agency for planned development, in the context of the coutry's expanding economy, the private sector will have the opportunity to develop and expand. The principle of cooperation should be applied wherever possible, and a steadily increasing proportion of the activities of the private sector to be developed along cooperative lines." It was, thus, clear that the adoption of the principle of socialist pattern of society did not mean the end of the private sector. Instead, the private sector was assigned and expected to play an important role in the nation's economy. The Industrial Policy Resolution of 1956, thus, reiterated the resolve to foster national development through a mixed economy.

The Resolution classified industries into three categories having regard to the role the State would play in each of them.

(i) The first category contained industries "the future development of which will be the exclusive responsibiltiy of the State." Industries in this category were listed in schedule A of the Resolution.It contained arms and ammunitions, atomic energy, iron and steel, heavy casting and forgings of iron and steel, heavy plant and machinery, heavy electrical plants, coal and lignite, mineral oils, mining, mining and processing of copper, lead, zinc, tin, molybdenum and wolfram, minerals in the schedule of atomic energy, aircraft, air transport, railway transport, ship building, telephone, telegraph and wireless apparatus and generation and distributio of electricity. It was also laid down that railways and air transport, arms and ammunitions and atomic energy are to be developed as central government monopolies.

(ii) In the Second category were included industries "which will be progressively State owned and in which the State will, therefore, generally take initiative in establishing new undertakings, but in which private enterprises will also be expected to supplement the effort of the State." With a veiw to accelerating their future development, the state will increasingly estbalish new undertakings in these enterprises. At the same

time, prive enterprise will have the opportunity to develop in this field, either on its own or with State participation. The industries listed in the second category were included in Schedule B of the Resolution. It contained all minerals except "minor minerals", aluminium and other non-ferrous metals not included in Schedule A, machine tools, Ferro alloys and tool steels, basic and intermediate products required by chemical industries, antibiotics, fertilizers, synthetic rubber, carbonization of coal, chemical pulp, road transport, and sea transport.

(iii) The third category contained all the remaining industries. "Their development will be undertakne ordinarily through the initiative and enterprise of the private sector, though it will be open to the State to start any industry even in this category. It will be the policy of the State to facilitate and encourage the development of these industries in the private sector, in accordance with the programmes formulated in successive Five Year Plans, by ensuring the development of transport, power and other services and by appropriate fiscal and toehr measures."

It was also made clear that division of industries into separate categories does not imply that they are being placed in watertight compartments. Inevitably, there will not be an area of overlapping but also a great deal of dovetailing between industries in the private and public sectors. It will be open to the State to start any industry not included in Schedule A and Schedule B when the need of planning so require or there are other improtant reasons for it. In appropriate cases, privately owned units may be permitted to produce an item falling within Schedule A for meeting their own requrements or as by-product. Further, it was mentioned that there will ordinarily be no bar on small privately-owned units undertaking production, such as the making of launches and other light craft, generation of power for local needs and small scale mining. Again, heavy industries in the public sector may obtain some of their requirements form private sector.

The Industrial Policy Resolution of 1956 reiterated the government's determination to provide all sorts of possible assistance for accelerated development of small and cottage industries in view of their distinct role in a capital-scarce economy with abundant supply of manpower.

Another important objective spelt out by the resolution was the removal of regional disparities in development through the accelerated development of the regions lagging industrially. The need to develop proper infrastructural facilities for industrial development in the back ward regions was emphasized in the Resolution.

The Industrial Policy Resolution of 1956 was announced after implementation of the Constitution of India, formulation of the Planning Commission and adoption of the policy for economic development through Five Year Plans. Hence, it was more pragmatic and objective-oriented than the 1948 Resolution. Instead of containing threat of nationalization of privately owned industries, the Resolution provided a definite area for the operation of the private sector. The Polciy of 1956 was designed to enable the government in due

course to gain a dominant position in the industrial sevtor of the country. In fact, in terms of this resolution, the task of raising the pillars of economic infrastructure in the country was entrusted to the public sector for reasons of its greater reliability, the very large investmnet requied and the longer gestation periods of the projects crucial for economic development. The Policy Resolution of 1956 therefore provided in very clear terms the basis for future industrial development of the coutnry.

4.5 The Indus;trial Policy of 1991

The economic reform process started here in 1991, while in China it began in 1979. The Industrial Policy of 1956 underwent changes in 1973, 1977 and 1980 to accommodate the changing requirements of the Indian economy. But gradually it was felt that the Policy of 1956, that reserved a dominant position for the public sector in the economic development, had vielded some results initially but in course of time bureaucratic decision making and lack of initiative for modernization made many of them unable to cope with the requirement of development. At the same time behind the licensing policy thre had developed a web of bureaucratic control that was time-consuming and corruption-prone. Moreover, behind a tariff-protected market, most Indian industries have not been able to be internationally competitive. Restrictions on the size of business through the Monopolies and Restrictive Trade Preactices Act had put a brake on reaching sufficient economy of scale in operation. Similarly, restrictions put on the inflow of foreign investment and technology through the Foreign Exchange Regulation Act 1973 also hindered the technological up-gradation of Indian industries and foreign investment in high-tech industries, which were necessary for accelerated development of Indian industries. Thus, a time came when the country was not in a position to pay for its imports. The situation necessitated a change in the industrial policy of the country for making Indian industries competitive, its public sector vibrant and creating a congenial environment for inflow of foreign investment and foreign technology for accelerating the pace of industrial development of the country. A big loan had to be taken from the IMF.

The Industrial Policy of July 24, 1991 introduced significant changes in the policy of industrial development of the country by incorporating the following features of reform:

Industrial Licensisng Policy : In the first place the Policy of 1991 laid down that the Industrial Licensing will be abolished except for a short list of industries related to security and stragic concerns, social reasons, hazardous chemicals and overriding environmental reasons and items of elitist consumption listed in Annex II. Similarly, the areas where security and strategic concerns predominate, will continue to be reserved for public sector as listed in Annex I. Originally the Annex I included eight items but it now includes only six items, such as, arms and ammunitions, atomic energy, coal and lignite, mineral oils, minerals specified to the Schedule to the atomic energy, and railway transport.

Foreign investment : It was decided that approval would be given for foreign direct

investment up to 51 percent foreign equity in high priority industries. There shall be no bottlenecks of any kind in this process. Such clearnance will be available if foreign equity covers the foreign exchange requirement for improted capital goods. Accordingly, the Foreign Exchange Regulation Act 1973 shall be amended. White the import of components, raw materials and intermediate goods, and payment of know how fees and royalty will be governed by the general policy applicable to other demestic units, the payment of invidends would be monitored through the Reserve Bank of India so as to ensure that outflows on account of dividend payments are balanced by export earnings over a period of time.

Other foreign equity proposals involving 51% foreign equity that ate not made in high priority areas will continue to need prior clearance. However, to provide access to international markets, majority foreign equity holding up to 51% will be alowed for trading companies that are primarily engaged in export activities. Both foreign direct investment and portfolio investment are now permitted.

Foreign Technology Agreements : The policy provided for automatic permission for foreign technology agreement in high priority areas up to lump sum payment of Rs. 1 Crore, 5% royalty for demestic sales and 8% for exports, subject to total payment of 8% of sales over a 10 year period from date of agreement or 7 years from commencement of production. The prescribed royalty rates are net of taxes to be calculated according to standard procedures. For industries other than those in the high priority category automatic permission will be given if no free foreign exchange is required for any payment.

All other proposals will need specific approval under the general procedure in force. However, no permission will be neseccay for hiring of foreign technicians, foreign testing of indigenously developed technogies. Payment may be made from blanket permits or free foreign exchange according to RBI guidelines.

Public Sector: Portfolio of public sector investments will be reviewed with a view to focus the public sector on strategic, high-tech and essential infrastructure. Whereas, some reservations for the public sector is being retained there would be no bar for areas of exclusive to be opened up to the private sector selectively. Similarly, the public sector will also be allowed entry in areas not reserved for it.

Public enterprises, which are chronically sick and which are unlikely to be turned around will, for the formation of revival/rehabilitation schense, be reffere to tbe Board for Industrial and Financial Reconstruction or other similar high level institutions created for the purpose. A social security mechanism will be creacted to protect the interests of workers likely to be affected by sucy rehabilitation packages.

In order to raise resoruces and encourage wider public participation, a part of the government’s shareholding in the public sector would be offered to mutual funds, financial institutions, general public and the workers.

Boards of Directors of public sector companies will be made more professional and given more powers. Further, there will be greater thrust on performance improvement throgh the Memorandum of Understanding system through which management would be granted greater autonomy and will be held accountable.

Monopolies and Restrictive Trade Practices Act: Some years ago it was announced that the Act will be amended to remove the threshold limits of assets in respect of MR TP companies and dominant undertakings. This will eliminate the requrement of prior approval of Central Government for establishment of new undertakings, expansion of undertakings, mergers, amalgamation and takeovers and appointment of Directos under certain circumstances. Emphasis will be placed on controlling and regulaitng monoplistic, restrictive and unfair trade practices. In accordance with the resolve to amend the MRTP Act for removing the hudles on the way to the expansion of business activites by those who are efficient and competitive, MRTP Act has been replaced by Competition Act 2002. The Act seeks to promote competition through prohibition of anticompetitive practices and abuse of dominance and regulation of companies beyond a particular size. Thus, the year 1991 marked the beginning of an era of Economic Reforms, based on three things: privatization, globalisation and liberalization.

4.5.1 Privatisation and Disinvestments

Privatisation is a prcess by which the government transfers its economic and commercial activities, represented by production and distribution under its ownership and control, to the private sector. Many countries of the world (the former socialist countries and a large number of devloping coutnreis of Asia, Africa and Latin America) launched massive programmes of privatisation of the public sector during 1980s and 1990s. Privatisation was resorted to in these countries primarily for reducing the budged deficits of governments resulting from investment of revenues in those sectors that needed huge investments but paid little in return. Subsequently, World Bank and IMF prescribed privatisation as a part of the economic reform in the poorer and erstwhile socialist countries for their entitlement to loans and toehr assistance from these agencies. Thus, gradually privatisation has spread all over the world as one of the requirements of economic progress.

The method of privatisation, adopted in the UK, consisted in conversion into public limited companies by the sale of government holdings. The shares were not off-loaded to another promoter. One of the greater advantage of this mehtod is the widening and deepening of the caital market. Beczause, opening of new investment opportunities in shares provided people a scope to looik beyond the government bonds and other secured but low-interest bearing investments.

Public sector in India : At the time of Independece, India was economically underdeveloped and technologically backward-basically an agrarian economy with heavy unemployement, low level of saivngs and investment, and a very narrow capital market. In the situation, the private sector was not in a position to shoulder the responsibiloity of

developing basic and key industries and the overall industrial infrastructre of the country. Thus, the entreprenurship of the state was visualized as the only way to develop these core industries and the infrastructure that needed massive investment. In pursuance of the policy of state entrepreneuship large investments wre made in buiding up capacity in a wide spectrum of infrastructure and industrial activities.

Prior to 1947 the publci sector in India included only the Railways, the POst & Telegraph, the Port Trust, the Ordnace and Aircraft factories and some state managed undertakings. But, as a result of the adoption of the new industrial policy in 1956, the number of public enterprises increaed from 5 in April 1951 to 240 in March 2003. During the same period the volume of investment increased from Rs. 29 crore to Rs. 2,52,554 crore. It can be mentioned hre that in industries like fuel, petroleum, basic metal and nonferrous metal industries the public sector accounts for major portion of the total national production. These industreis provide linkages to a host of other industries, and thus the public sector gradually became the backbone of the industrial economy of India.

Privatisation and Disinvestment : While the government had been expanding the horizon of public sector in conformity with its socio-political objective of a socialistic pattern of society, there has been mounting criticism of their poor performance in the context of growing beudget deficit.

So the Industrial Policy of 1991 restricted the role of direct state entrepreneurship in the industrial development of the country. It suggested drrastic redution int the numbe of reserved industries from 17 to ultimately only 5 and at the same time requred the state to withdraw itself or limit the size of its stake in selected enterprise thorugh disinvestments of its holdings in such enterprises. Further, by stressing the role of profesisonal management and competition with private sector in raising efficienty, the policy finally relied upon the market mechanism for making Indian industreis competitive and vibrant.

Privatisation can be accomplished in two different ways. In the first place, it may be done though opening up of such areas for enterpreneurship of the private sector, which were hitherto monopolized by the public sector. Recent public-private partnership ventures are a step towards that goal (e.g. in port development). Secondly, it may imply change of ownershp of exiting public enterprixes in favrour of the private sector. Of the two different processes mentioned above, the new policy attached more importance ot the first process, that is, widening the area of operation of the private sector though reducing the number of industries so long reserved for the public sector.

Since the announcement of the new industrial policy the government has opened for private investment, both foreign and Indiann, a number of industries such as, electricity, and road transport, air transport, telecommunication, mines, minerals, and metals.

Side by side direct privatization through sale of majority share to the private sector has also been resorted to on a moderate scale. It has also been observed that, direct privatization evokes serious resistance from political parties and worksers principally because

of fear of loss of job by the employees and in some cases unfillingness in surrendering the profit making enterprises to the private sector. In some cases, because of non-existence of a developed capital market, the government ahs to depend upon private bidders for sale of its enterprises at prices offfered by such byyers. Thus, though there is a strong case in favour of direct privatization in reality it was becomming increasingly difficult to push through the proposals of such privatization. Accordingly, in August 1996 the Disinvestments Commission was set up. Subsquently, a ministry was also created at the center for looking after the disinvestment of central public sector enterprises.

Since the adoption of the new policy the goverent has been setting targets in the annual budgets every year for disinvestment of its holdings in public sector. Ffom the beginning of disinvestments in 1993-94 the highest amount, so far, of Rs 15,547 crore was realized in 2003-04. A number of reasons may be ascribed to this limited sucdess. The most important of them being the non-acceptability of shares of public enterprises in the capital market. Again, the token privatization to the extent of 10-20 per cent does not enthuse either the Indian or the foreign investors to risk their capital for the obvious reason that, with a marginal holding they will not be able to exercise any purposeful control over the management of such enterprises. The other reason is resistance from trade unions, opposition political parties and intellectuals agains the sale of holdings of the state in the profitable enterprises to the private sector. Thus, it appears that the government has not been able realize the target of privatization perfectly either through direct sale or though disinvestment. In 2003, the Supreme Court of India had given its verdict against the privatization of public sector firms without specific approval of the Parliament of India, The verdict has put the government in a very awkward position in pursuing its disinvestment policy, particularly in case of profit-making industries. However, after the UPA government came to power in 2004, the Ministry of Disinvestments has been abolished, though the policy of the government towards disinvestments has remained unchanged.

4.5.2 Financial Sector in India

The policy of liberalization covered not only the real sector of production but also the fiancneial sector. The financdial sector (system or market) is the link between demand for and supply of finance or funds of all kinds. The players in this sector can be classified into three: the household sector, the business sector and the government. Thse palyers both supply and demand funds. For supplying funds certain institutions come into existence. For facilitaing the passage of funds from sources of supply to the points of demand certain institutions, instruments and practices are there. This web of institutions, instruments and practices to acilitate the supply of finance is called the financial market. The ultimate source of funds in a country is its savings. These saivngs make possible investment (capital formation) and development. Only a part of those savings does not go through the financial market - the taxes collected by the government and the ploughed back profits of business.

The financdial market has two parts: 1) money market or market for very short-term near-money assets (e.g. treasury bills), and 2) the capital market or the market for medium-to-long term debt funds (shares, bonds, loans etc.).

In India, an old fashioned capital market, consisting of indigenous bankers and money lenders, originating more than 3000 years agom functions even today, for small traders and agricultursts. But udner the impact of a steadily developing modern-type capital market and government efforts to prevent lending at exessively high interst rates changed by those agencies, this market has tended to wither away at some places and has been forced to either withdraw or reorganise itself.

The modern capital market of India came into existence in the later part of the 18th century. While a stock-market was functioning, where sale and purchase of the securities of the East India Company used to take place, the first western-type commercial bank (the Bank of Hindustan) was founded in Calcutta in 1770. At independence in 1947 the modern type capital market of India consisted of a British-type central bank, called The Reserve Bank of India, a number of British type private commercial banks led by the Imperial Bank of India a number of private insurance companies, the managing agency houses (mostly British) through which British capital was channelised to India, and some credit co-operatives (mostly for agriculturests). There was virtually no agency for supplying long-term or risk capital to business. Ths represented a major gap in the financial system.

There was a sea change in the financial market scenario after 1947. First, there was a wave of nationalization, starting with the nationalization of the Reserve Bank of India in 1949, the Imperial Bank in 1955 and the nationalisation of schedule commercial banks in two phases, the first phase coming in 1969. The second, but more important, a number of development finance institutions came to be set up, one after another, for supplying and facilitating the flow of risk capital and long-dated loans to business for promoting economic development which was never uppermost in the minds of the British rulers in British India. All along there was an increasing control of the State over business (Capital Issues Control Act, Licensing, etc.). This state was almost authoritarian in the economic domain.

But, this boom in State activities could not last long. Corruption, inefficiency started taking a heavy toll primarily in the form of losses and increase in non-performing assets (NPA) or ban unrecoverable loans (for commercial and development banks in particular). So, the 1991 economic policy put an end to ever gorwing state control and ownership of financial as well as non-financial firms. The new policy was expected to stop an excessive drainage of public money to inefficinet concerns and departments. An era of financial sector reforms dawned simultaneously. Strengthening of the financial sector and improving the functioning of the financial market are the core objectives of financial sector reforms in India. The central plank is a set of prudential norms aimed at imparting strength to banks and financial institutions. These norms include not only capital adequacy, but also accounting standards, exposure and disclosure norms, investment and risk management guidelines. The enactment of the Securitisation Act of 2002 has improved the recovery process of non-performing assets (NPA).

Financial Liberalisation : Financial liberalization has been a multi-phase process. To make the financial system responsive to the needs of economic development, since the mid-eighties, the RBI appointed different committees. It also implemented several recommendations of the two committees apointed by it, such as Chakraborty Committee and Voughal Committee, in a phased manner and by the late eighties significant deregulations of the short-term sector of the financial markets in India had taken place. But, the real inducement for reform of the financial sector came in 1991 with the adoption of the policy structural adjustment of the Indian economy for implementation of the new economic policy. A vibrant and competitive financial system became necessary to sustain the ongoing reform in the structural aspect of the real economy. Thus, on August 14, 1991 the Committee on Financial System was appointed under the Chairmanship of Sri Narasimham. "The Committee's approach to the issue of financial sector reform is to ensure that the financial services industry operates on the basis of operational flexibility and functional autonomy with a view to enhancing efficiency" (Report of the Committee on Financial System, 1991 p-ii). The Committee submitted its report on Novermber 14, 1991. The report of the Committee constituted the basis of financial sector reform in India. The principal recommendations of the Committee related to the following. (a) To bring down the SLR of banks in a pahsed manner to 25 percent over a period of about 5 years. (b) To use the CRR of banks as an instrument of monetary policy and not as a means of controlling the secondary expansion of credit. The Committee also recommended that the interest rate paid to banks on their SLR investmnets and on CRR in respect of impounded deposits above the basic minimum should be increased. (c) To phase out directed credit programmes and redefine the priority sector by including in it small and marginal farmers, the tiny sector of industry, small business and transport operators, village and cottage industries, rural artisans and other waker sections. The credit target of the redefined priority sector should be 10 percent of the aggregate credit. (d) To bring down interest rate on borrowing in line with other market-determined interest rates and phase out all concessional rates of interest for the sake of macro-economic discipline. (e) Banks and financial institutions should achieve a minimum 4 percent capital adequacy ratio in relation to risk weighted assets by March 1993. (f) The banks whose operations have been profitable should be permitted to raise capital through fresh issues in the capital market. (g) Banks and financial institutions should adopt uniform accounting practices, particularly in regard to income recognition and provisioning against doubtful debts. (h) In respect of banks and financial institutions, which are following the accrual system of accounting, no income should be recognized in the accounts in respect of non-performing assets. (i) Balance sheets of banks and financial institutions should be made more transparent and full disclosure shold be made in balance sheets as recommeneded by the International Accounting Standards Committee. (j) The structure of banking system should evolve towards a broad pattern consisting of large banks, national banks, local banks and rural banks. (k) Branch licensing shold be abolished and the matter of opening and closing of branches be left to the commercial decision of the individual banks. (l) To liberalise policies towards

foreign banks with respect to opening and closing of branches. Foreign banks, when permitted to operate in India, should be subjected to same requrements as are applicable to domestic banks. (m) The development financial institutions should have full operational flexibility and adequate internal autonomy in matters of sanctioning and disburshing loans.

A number of recommendations of the committee were implemented without much delay. To begin with, the CRR and SLR were reasonably reduced in a phased manner since 1993-94. Secondly, the structure of lending rates was rationalized and the rates of interest were substantially reduced from 1992-93. Thirdly, for proper internal debt management auctioning of 364 days and 91 days Treasury bills were introduced from 1992-93. In the fourth place, as capital adequacy measures for banks, a risk-asset ratio system was introduced since 1991-92. A system of income recognition and provisioning for non-performing loans was also introduced. Fifthly, in order to encourage healthy competition among the banks and financial institutions for improvign the efficiency of the money and capital markets, branch-licensing policy has been liberalized. Similarly, the process of establishment of new banks in the private sector has also been simplified and the banks have been allowed to raise capital from the capital market by fresh share issues for augmenting their resources. In the sixth place, the banks and financial instituions have been given the liberty to determine their lending and borrowing rates according to commercial consideration. Lastly, restrictions on pricing of capital issues have been removed and the functions of Controller of Capital Issues transferred to The Securities & Exchange Board of India (SEBI) for providing autonomy to the issuers of securities and proficidng adequate protection to the investors. The SEBI provides guidelines from time to time for issuing securities for ensuring full disclosure of all information pertaining to the issue and at the same time requires the merchant bankers and issue managers to be particular about their role in protecting the interest of the investors. The nationalised insurance sector was thrown open to private players, both domestic and foreign, to create a more vibrant and competitive atmosphre with greater efficiency, choce of insurance products and satisfaction to customers.

Thus, financial liberalization in India became a part and parcel of the structural adjustment for implementation of the new economic policy since 1991. During the period of more than a decade since the introduction of financial sector reform, as outlined above, some positive impact on the system has become apparent. It can be mentioned here that as a result of the introduction of financial sector reform there has been considerable improvement in the profitability of the banking system in terms of operating and net profits. What is more important is that the intermediation process has improved, as evident from decline in the ratio of net interest income to total asset of public sector banks from 3.16 in 1996-97 to 2.84 in 2000-01. Further, since the introduction of fincancial sector reform since the early 1990s, the profile of asset portfolio has improved and the extent of net non-performing loans (NPLs) as percentage of total assets has declined. Banks are allowed to invest in overseas money markets (while individuals and listed companies can invest in overseas companies).

Financial liberalization was closely followed by financial crisis in many countries of Latin America, East Europe and East Asia. The major lesson from the cirisis is that deregulation and internationalization could trigger a crisis if undertaken without adequate structural safeguards. India therefore needs to strengthen the financial sector through reforms, particularly institutional capacity building. The people of India deserve financial services and the institutions that meet their expectations. This required dymanic prudential and supervisory norms that anticipate and manage systemic risks proactively. The last quarter of the 20th century was characterized by widespread movement towards financial liberalisaion across the world.

4.5.3 Conclusion on Reforms

Liberalisation has meant relaxation/removal of govt. controls on ability of companies to start business, finance risk capital, close units, expand capacities, price their shares and procure foreign exchange. Parvatisation has meant reducing govenrment ownership below 50% in certain cases and even to zero in others, saying goodbye to the nationalization craze of the 1960s and 1970s. While economist have viewed globalisation as the removal of barriers to free trade and as a mens to crate one global market, sociologists have described it as the intensification of world wide social relations where local events are shaped by happenings in distant places. Although it promotes economic growth by presurizing economic efficiency and product quality, widening profit opportunities and export income, it has missed out so far on the goals of equity, poverty eradication and enhanced human security.

However, after a decade of the Reforms, the economic health of the coutnry has improved, stock markets are booming, trade is rising and foreign investors are chasing deals in India. Foreign exchange reserves have crossed $100 billion (early 2005 position), and India has repaid some of its loans to the IMF.

This however does not mean that India has regurned to Adam Smith's dreamland of the neutral police state. The government has retained control in crucial areas and over crucial products and services in the interests of the community. Only undue and unnecessary interference in private enterprise has gone. Labour law reforms are, however, yet to be done.

4.6 Summary

Government's economic policy is a vital factor in the economic environment of business. In British India there was no industrial policy really speaking. The first policy announcement of free India came in 1948. The industrial policy, announced in 1956, was intended to ensure planned growth under large-scale State participation in major sectors. The public sector was to lead development. But the 1991 industrial policy statement reversed the situation by reducing governments era of operation. It aimed at three things : privatization, liberalization and globalisation.

4.7 Exercise

Essay type questions :

1. Examine the natrue of the economic environment of business.
2. Define and explain economic system. State the principal characteristics of different economic systems.
3. State the principal features of the Industrial Polciy 1956 and mention how it sought to secure a socialistic pattern of soceity.
4. Critically examine the Industrial Policy of 1991.
5. Write an essay on financial liberalization in India.
6. Examine the financial system of India with special reference to its evolution in the last two centuries.

Short answer type questions :

1. What are the principal determinants of the environment of business?
2. Trace the evolution of Laissez-fare capitalism.
3. State the principal features of the Industrial Policy of 1948.
4. Distinguish between a socialist and a non-socialist economy.
5. State the approach of Industrial Policy of 1991 towards the Indian public sector.
6. Mention the principal recommendations of the Narasimham Committee on financial liberalization.
7. What is a capital market?

Objective type questions :

1. Wiorkers and their unions in business unit form a part of

   (a) environment

   (b) political environment

   (c) policy of government

   (d) economic environment.

2. The first industrial policy of India was announced in

   (a) 1951

   (b) 1956

(c) 1948

(d) none of the above.

3. Economic planning was introduced in India in

   (a) 1948

   (b) 1951

   (c) 1950

   (d) none of the above.

4. Privatisation of public sector first began in

   (a) United Kingdom

   (b) USA

   (c) India

   (d) Soviet Union.

5. A treasury bill is an instrument

   (a) of money market

   (b) of capital market

   (c) of both money and capital markets

   (d) none of the abvoe.

6. Financial liberalixation has led to

   (a) increase in non performing assets of commercial banks in India

   (b) decrease in non performing assets of comemrcial banks of India

   (c) has activated the new issue market

   (d) none of the above.

Answer : 1(d), 2.(c), 3. (b), 4. (a), 5(a), 6(d).

4.8 References

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