
UNIT 17 INDIAN TRADE POLICY: HISTORICAL PERSPECTIVE AND RECENT DEVELOPMENTS

Structure

- 17.0 Objectives
- 17.1 Introduction
- 17.2 India's Trade Policy since 1950s
- 17.3 Components of India's Trade Policy Reforms since 1990
 - 17.3.1 Tariffs and Non-tariff Barriers (NTBs)
 - 17.3.2 Institutional Setting for Trade Policy Formulation
 - 17.3.3 Export Promotion Measures
 - 17.3.4 Exchange Rate Management
 - 17.3.5 Some highlights of India's Trade Policy at Present
- 17.4 India's Trade Performance: 1950-2004
 - 17.4.1 Trends of Trade Shares
 - 17.4.2 Growth of Trade
 - 17.4.3 Composition and Direction of India's Trade
- 17.5 India's Trade: Strategic Considerations
 - 17.5.1 Trade and Economic Growth
 - 17.5.2 Trade-FDI Nexus
 - 17.5.3 Trade in Services
 - 17.5.4 Regional Trading Arrangements (RTAs)
- 17.6 Let Us Sum Up
- 17.7 Key Words
- 17.8 Some Useful References
- 17.9 Answers/Hints to Check Your Progress Exercises

17.0 OBJECTIVES

The main objectives of this Unit are to provide (i) a brief historical background of the various trade policies that India has been following since independence, (ii) how and why trade policies have been changing over the years and (iii) in what way such changes in trade policies are reflected in India's economic performance. After going through this Unit, you will be able to:

- learn about different kinds of trade policies that a country may have at its disposal and what purposes do they serve;
- understand the evolution of India's trade policies over the last five decades;
- discuss patterns of India's trade and how it has been changing over time;
- describe the geographical direction of India's trade and its changes over time; and
- review India's strategic considerations for trade.

17.1 INTRODUCTION

The well known economist D. H. Robertson has immortalised the role of trade in development with his famous statement that "trade is an engine of growth". The policy makers and economists in India always took seriously trade policies to attain development objectives. In fact, trade policies played a very crucial role in India's planning for industrialisation.

intervene with the trading environment of a country. You have learned in Unit 4 about the major instruments of trade policy: tariffs, quotas, and subsidies. By trading environment of a country we mean the nature of existing trading relationships that the country in question maintains with various countries of the world. For example, a country may decide to close its borders so that no exchange of goods and services with other countries is possible. Or else, the country may allow inflow and outflow of goods and services between countries without any restrictions. Alternatively, a country may find it desirable to form trading arrangements with respect to one or a group of countries where all restrictions are removed with respect to the particular country or the group of countries but yet maintains certain restrictions with respect to all other countries. You have learned about such regional trading blocks in Unit 15. These are policy issues that a country may like to consider to attain certain aims and objectives at any given point in time. As you will understand shortly, trade policies play important roles in economic development of a country. It turns out that with the changes of time and the structure of the economy, the nature of the desirable trade policies also changes.

India has used some mixtures of the above trade policy instruments to restrict or expand its trade. India's trade policy has always been very intricately related to its development objectives. At the dawn of India's independence, the main objective before the country was to achieve rapid economic growth and removal of poverty. Most economists and policy makers then thought that the appropriate strategy of trade policy to achieve such goal should be protectionist and hence the country had followed import-substitution strategy of industrialisation (ISI) for rapid economic growth, which you have learned about in Units 4, 11 and 12. Over the past five decades there has been a sea change in India's trade policy and what was thought to be appropriate trade policy strategy in the early days of planning has subsequently considered being detrimental to growth and development. Thus while fifty years ago there was a consensus among economists and policy makers that an appropriate trade policy was one, which protected infant industries in the country, today there is a consensus in favour of an export oriented trade policy.

17.2 INDIA'S TRADE POLICY SINCE 1950s

During the second and the third plan period India had adopted a very restrictive trade policy regime for reasons as discussed below. As mentioned above, at the time of independence Indian exports were heavily concentrated both in terms of commodities and geographically. Three primary goods, cotton, jute and tea accounted for almost 70 percent of India's exports and in all of these goods India was a significant exporter so that further increase in share of world exports would be difficult. Also almost 60 percent of the exports went to the UK. Furthermore, there was very limited development of manufactures in the country. In these circumstances it was believed that it would be difficult to increase exports, both of primary and manufactured goods. In the First Plan and the initial years of the Second Plan the government depended on its accumulated foreign exchange reserves, the Sterling Balances, to pay for the import of capital goods and also to finance the deficit in the government's budget because of the increased investment. But the foreign exchange reserves were depleted by the middle of the Second Plan precipitating a BOP crisis. From this period till the end of the Third Plan the government depended on

foreign aid, mainly from the US and the World Bank to finance its investment and the resulting BOP deficit. Foreign aid during the Second and Third Plans was about 3 percent of GDP and financed about 25 percent of India's investment and a third of public investment.

For these reasons the government put into place a *stringent QR regime* to restrict imports to the amount of foreign exchange available. *Imports of only those goods were allowed that were considered essential and were not produced at home*¹. The large BOP deficits were not sustainable and in the Third Plan the government made policy changes to increase exports and reduce the BOP deficit. The main change was that the government started to *subsidise exports*. There were many different rates of subsidy. Also the number of bands for levying import duties also increased. The QR regime also was very complex. In all, India's trade policies had been very restrictive.

However, there was a growing realisation that import controls were counter productive in the long run. Consequently, when the country faced a BOP crisis in the early eighties because of higher oil prices there was no attempt to further increase the restrictiveness of the import control regime. This was a change from the reaction in previous BOP crises. *The nineties have seen a fundamental change in India's trade policies*. This change has been precipitated by a number of factors. Despite rapid growth the economy remained fragile and vulnerable. The Middle East crisis of the early nineties coupled with domestic political instability shook the confidence of foreign lenders, and India faced a very severe BOP problem. The response to this crisis was very different from that to previous crises. Whereas previous crises had resulted in some changes, the basic policy framework of import substituting industrialisation behind very protective walls had been maintained.

Among the developing countries, it may be worthwhile to mention that India was the first in initiating industrialisation but the last in trade liberalisation. This may seem true to a large extent because in the *First* place, till the early 1980s, the pattern of trade policy in India reflected its policymakers' preference towards export-pessimism and ISI strategy. *Second*, by the first half of 1980s, even when the importance of liberal trade policy came to be increasingly recognised and the Indian government set up a number of Expert Committees to look into the gamut of trade policy. Despite the valuable recommendations of these committees, the trade policy pattern continued to be characterised by time-worn licensing regime, which along with high tariff wall protected the economy from external competition. *Third*, the impetus for trade reforms in early 1990s was provided by global developments whereby export promotion and trade integration became the policy objective of most of the developing world. *Fourth*, specific to India's BOP crisis in 1990-91, there was hardly any option but to embark on comprehensive economic reforms and trade policy formed an integral part of the overall structural reform process. The Indian trade regime was one of the most protectionist, much more than that of other developing countries. Trade reforms as a kingpin of overall external sector reforms were initially conditioned by the need to correct the deficiencies that led to the balance of payments (BOP) crisis in 1991. For this,

¹ See Bhagwati and Desai (1970) and Bhagwati and Srinivasan (1975) for a discussion of India's trade policies.

inappropriate exchange rate regime, unsustainable current account deficit and a rise in short term debt relative to official reserves were considered to be the major factors responsible for the immediate crisis. *Finally*, there was also international pressure in the nineties. There was therefore pressure during the multilateral trade negotiations, known as the Uruguay Round, for India to reduce its tariffs and quantitative restrictions.

Check Your Progress 1

1) Why did India delay its trade policy reforms?

.....

.....

.....

.....

2) Do you justify a case for trade policy reforms in India?

.....

.....

.....

.....

3) List three main causes of BOP crisis in India in 1991.

.....

.....

.....

.....

17.3 COMPONENTS OF INDIA'S TRADE POLICY REFORMS SINCE 1990

External sector reforms beginning with 1991 included dismantling of trade restrictions along with tariff rationalisation, a move towards current account convertibility, liberal inflows of private capital, removal of restrictions on dividends, royalties, technical fees outflows and gradual liberalisation of restrictions on outflows involving residents. To be more specific, the trade policy changes included simplification of procedures and removal of procedural bottlenecks, removal of QRs, broadening of export incentives and export promotion schemes to a large number of non-traditional and non-manufacturing exports, strengthening the export production base, technological upgradation and improvement of product quality, identification of thrust areas and thrust products, shift from direct export subsidy to indirect promotional measures and phased removal of all BOP related QRs by 2001. Some of the major components of evolving trade policy are explained below.

17.3.1 Tariffs and Non-tariff Barriers (NTBs)

A significant aspect of the trade reforms of the 1990s was the reduction in the then prevailing very high import duties (over 300 percent in some cases). Since

then, the peak rate has come down progressively from 150 percent in 1991-92 to 25 percent in 2003-04 and 15 percent in 2005-06 in case of non-farm goods. The government is committed to reducing tariffs to the levels comparable with those prevailing in East Asian countries in the near future. For instance, the weighted average import duties on various goods even though reduced from the earlier high levels are still higher in India from those of some of East Asian countries.

As against 28.5 percent of weighted average duty in India in 2000, China had 14.7 percent; Philippines, 3.8 percent; Thailand, 10.1 percent in the same year. More so, additional customs duty in India seems to continue on products that attract very low basic duty. But products covered by Information Technology Agreement attract only 4 percent tax.

The most common NTBs are the restrictions or prohibitions on imports maintained through import licensing requirements. Having been mostly justified on BOP basis, 80 percent of tariff lines were subject to some form of import licensing restrictions in mid-1990s. India started removing these restrictions since 1996 and virtually there are no such restrictions any more. As a result, the share of unrestricted products under imports increased to more than 95 percent in 2003 from about 61 percent in 1996. The remaining 5 percent of tariff lines are permissible under Articles XX and XXI of GATT on the grounds of health, safety, moral conduct and essential security. More so, the proportion of canalised items in total imports in value terms declined from 27 percent to 19 percent between 1988-89 and 1997-98.

17.3.2 Institutional Setting for Trade Policy Formulation

While the Ministry of Commerce has the main responsibility of formulating India's trade policy, it also seeks policy inputs from its various autonomous bodies such as Export Promotion Councils, Commodity Boards, IIFT, FIEO to boost exports. Along with its ritual of Export-Import (EXIM) Policy, the Central Government Budget also announces certain policy measures impacting upon India's trade in particular and external sector in general. EXIM Policy over the years, was an annual feature of the Ministry of Commerce, but in 1985, a three yearly EXIM Policy was introduced to provide a definite focus to the trade sector. In post-reform period, this policy was replaced by a five yearly policy in March 1992 (EXIM Policy 1992-97) to impart greater stability and carry forward the process of trade liberalisation.

Another milestone in institutional innovation in early 2002 was the government's unfolding of its Medium Term Export Strategy (2002-07). This document provided a vision for creating a stable policy environment with indicative sector wise target, with a mission to achieve 1 percent of global trade by 2007. In the same year, the new EXIM Policy (2002-07) was also announced, which seeks to achieve an environment free of restrictions and controls. Synergy between these policies/strategies is expected to realise India's strong export potential and enhance the overall competitiveness of its exports. Further, in August 2004, the government announced a comprehensive Foreign Trade Policy 2004-09 (FTP 2004) with the basic objective to double India's share of global merchandise trade by 2009 and to make exports an instrument of growth and employment generation.

Considering exports as a national priority, the Finance Ministry also constituted Expert Committees on tax reforms, tax administration, customs tariffs in post-reform period. After the Tax Reforms Committee headed by Raja. J. Chelliah and its recommendations concerning tariff rates and their dispersion announced in 1992, another committee known as Finance Ministry Task Force (Kelkar Committee) on indirect taxation in 2002 suggested reforms in areas related to customs tariffs, rationalisation of export promotion schemes, trade facilitation and other changes in tax administration. (Economic Survey, 2002-03, p.113)

17.3.3 Export Promotion Measures

While a number of existing export promotion schemes such as incentive related to Duty Free Replenishment Certificate (DFRC), Duty Entitlement Passbook (DEPB), Export Promotion Capital Goods (EPCG), Advance License have been modified, refined and rationalised from time to time in the post-liberalisation period, significantly the formulation of innovative schemes/projects to realign India's trade strategies and priorities with the global trade dynamics have attracted much more attention recently. A major hindrance to exports has been the high import duties that producers have to pay on imported inputs and capital equipment. This makes it difficult for them to compete in the world market. To solve this problem, EPZs, EOUs, Technology Parks and lastly Special Economics Zones (SEZs) have been on the forefront in this regard. Export Processing Zones (EPZs) were established as enclaves separated from the domestic tariff area by fiscal barriers and were intended to provide duty free environment for export production at competitive cost. Many of these EPZs have been converted into Special Economic Zones since 2000. Policy measures announced in the successive Union Budgets have included a comprehensive package for development of SEZs including their entitlement to procure duty free equipment, raw material and components. Export Oriented Units (EOUs) were set up as complementary to EPZs under which a unit could be set up at any location (including EPZs) and enjoy liberal package of incentives at par with EPZs. Again software Technology Parks (STP) for IT and IT-related exports and Electronic Hardware Technology Parks for electronics were launched to give push to these sectors. Recent addition to these schemes has been Agriculture Economic Zones (AEZs) to promote the export of agro and agro-based products. It is not only the decontrol and deregulation of the agriculture sector to boost farm exports, the government also provides assistance to the state governments in developing necessary infrastructure, availability of credit and other facilities for these products.

Keeping in view the objective to developing India as a global hub for manufacturing, trading and services under FTP 2004, the strategic measures included to identify and nurture focus areas like agriculture, handloom and handicrafts, gem & jewellery, leather and footwear and marine products; simplification of procedures and neutralisation of incidence of all levies and duties on inputs used for exports. For example, export promotion schemes such as "Vishesh Krishi Upaj Yojna" and "Served from India" have been announced to accelerate the growth of agriculture, floriculture, horticulture products and services exports. Further, some thrust areas for policy implementation during 2005 included introduction of Electronic Data Interchange, Central SEZ Act to enable world class infrastructure through private participation and a simplified regulatory policy frame in the SEZs; greater

flexibility to exporters in their foreign exchange transactions such as up to 360 days to realise the proceeds of exports on consignment basis and gold card scheme for medium and small exporters. In April 2005, under FTP, major procedural simplifications with a view to reduce transaction costs were announced and an Inter-State Trade Council was set up to involve states actively in the export efforts.

17.3.4 Exchange Rate Management

Following two stage devaluation of the Indian rupee in quick succession in July 1991, the government introduced Liberalised Exchange Rate System (LERMS) with a view to allow the exchange rate to reflect the scarcity of foreign exchange. However in 1993, this system was replaced by a policy of unified exchange rate mechanism. Under this, exporters and other foreign exchange earners could convert their 100 percent foreign earnings at market rate. Thus presently, the exchange rate of the Indian rupee is determined by the supply and demand conditions in the foreign exchange market. RBI stands ready to intervene to maintain orderly market conditions and to curb excessive speculation.

17.3.5 Some highlights of India's Trade Policy at Present

- Most goods freely importable on payment of specified customs tariff
- No quantitative restrictions on imports of capital goods and intermediates
- Concessional customs duty for capital goods imports
- Duty drawbacks on import of capital goods and inputs against export obligations
- Limited "Negative List" of imports and exports principally on grounds of security, health and environmental protection
- Export-promotion package, including income tax-exemptions, duty-free imports of capital goods and raw material
- Current account convertibility of the rupee
- Ongoing rationalising of customs tariff levels.

Check Your Progress 2

- 1) Do external sector reforms overlap trade policy reforms?

.....

.....

.....

.....

- 2) Distinguish between tariff and non-tariff barriers and some examples of NTBs.

.....

.....

.....

.....

3) Highlight the organisational set-up in formulating trade policy in India.

.....

.....

.....

.....

4) Elaborate important export promotion measures including major innovative schemes launched in recent years.

.....

.....

.....

.....

17.4 INDIA'S TRADE PERFORMANCE: 1950-2004

In this section we discuss India's trade performance since 1950. By trade performance we mean the following: (1) share of exports and imports in world exports and imports and in total world trade, (2) growth rates in exports and imports, (3) concentration and diversification of commodity composition of trade, (4) concentration and diversification in geographical direction of trade and (5) ratio of trade to gross domestic product (Trade/GDP) as a measure of openness of the country.

17.4.1 Trends of Trade Shares

India's share in total world exports in 1950 was 1.85 percent and the share in total world imports was 1.71 percent. The share of both exports and imports in total world trade was 1.78 percent. These shares have decreased to 0.42 percent, 0.72 percent and 0.57 percent in 1980. This shows that India has poorly performed in trade and many economists argue that this dismal performance was entirely due to India's restrictive trade policies. However, intensities of restrictiveness has been decreasing since the 1980s and we observe this in gradual rising of these shares since 1980. Both exports and imports have registered a significant increase over the years both in terms of value and its share in world trade.

Table 17.1: Export and Import of India and its Share in World Trade

Year	Exports (US \$ Million)		India's share in world exports (%)	Imports (US \$ Million)		India's share in world imports (%)	India's trade share in world Trade (%)
	India	World		India	World		
1980	8586	2033075	0.42	14864	1470317	1.01	0.67
1990	17969	3493575	0.51	23580	2639027	0.89	0.68
1995	30630	5168919	0.59	34707	3596565	0.97	0.75
1999	35667	5705869	0.63	46979	4155887	1.13	0.84
2000	42379	6435732	0.66	51523	4610295	1.12	0.85
2001	43361	6177370	0.70	50392	4425677	1.14	0.88
2002	49250	6465239	0.76	56517	4553360	1.24	0.96
2003	57085	7490263	0.76	71238	5258424	1.35	1.01
2004	71786	8975589	0.80	94060	6174947	1.52	1.09

Source: UNCTAD Handbook of Statistics 2005

The export has increased from 8586 million dollars in 1980 to 17969 million dollars in 1990 and to 71786 million dollars in 2004. India's share in world export has increased over the years. It has increased from 0.42 percent in 1980 to 0.80 percent in 2004. Similarly, India's imports too have experienced a significant rise over the years. It has increased from 14864 million dollars in 1980 to 94060 million dollars in 2004. The share of imports of India in world imports has also increased from 1.01 percent in 1980 to 1.52 percent in 2004.

17.4.2 Growth of Trade

As far as the growth of exports and imports are concerned, it is evident from Table 17.2 that India has performed better than the world growth rates in recent years and is moving in tandem with developing economies of Asia. India's exports have registered a growth of 25.8 percent in 2003-04. The corresponding growth rate for developing economies of Asia and World is 25.3 percent and 19.8 percent respectively. Similarly the imports of India have grown at a rate of 32 percent during the same period. The corresponding growth rate for developing economies of Asia and World is 28.9 percent and 20.3 percent respectively (see Table 17.2).

Table 17.2: Growth of Trade

Year	Exports			Imports		
	India	Developing Asia	World	India	Developing Asia	World
1980-85	2	-3.9	-0.7	0.8	1.8	-0.6
1985-90	15.7	15.7	12.4	8.8	14.7	12.4
1990-95	11.5	12.6	7.7	8.1	13.7	7.1
1995-99	5.3	5.5	3.6	7.9	2	4
1999-00	18.8	23.7	12.8	9.7	24	13.6
2000-01	2.3	-6.9	-4	-2.2	-5.9	-3.8
2001-02	13.6	9	4.7	12.2	8.6	3.7
2002-03	15.9	18.8	15.9	26.1	19.6	16.1
2003-04	25.8	25.3	19.8	32	28.9	20.3

Source: UNCTAD Handbook of Statistics 2005

17.4.3 Composition and Direction of India's Trade

The impact of trade reforms can be observed from the changing structure of India's foreign trade in terms of diversity of production and markets and also in the form of higher degree of trade openness. India's export basket has changed in favour of technology-intensive and manufactured products along with high value-added agricultural products. India's trade is no longer confined to a few rich developed countries; developing countries have also emerged important markets for India's exports and its source of imports. Importantly, composition of imports has also changed in the post-liberalisation period.

A glance at structure of India's exports reveals that its manufactured exports accounted for more than three-fourths of its total exports during 1990s and subsequently. However, relative importance of these export products show that chemicals and allied products, engineering goods, readymade garments, gems and jewellery have been the key drivers of this phenomenal growth. While the importance of primary products in the export basket witnessed a decline during 1990s and early years of the new millennium, a new category of exports viz., petroleum products exports have shown a high rise since 2000 (See Table 17.3).

Table 17.3: Structure of India's Exports

	% Share in Trade			% Share of Total Exports		
	1990-91	1995-96	2002-03	1990-91	1995-96	2002-03
Primary Products	4.3	7.3	8.3	23.8	22.8	15.8
Agriculture and allied products	3.3	6.1	6.4	18.5	19.1	12.2
Rice	0.3	1.4	1.1	1.4	4.3	2.1
Marine Products	0.5	1.0	1.4	2.9	3.2	2.6
Ores and Minerals	1.0	1.2	1.9	5.3	3.7	3.6
Iron ore	0.6	0.5	0.9	3.2	1.6	1.6
Others	0.4	0.7	1.0	2.0	2.1	2.0
Manufactured Goods	13.0	23.7	38.4	71.6	73.9	72.7
Leather and Manufactures	1.4	1.8	1.8	8.0	5.5	3.4
Chemicals and Allied Products	1.3	2.4	4.7	7.2	7.4	9.0
Engineering	2.2	4.4	8.4	12.4	13.8	15.9
Readymade	2.2	3.7	5.4	12.3	11.6	10.2
Textile yarn	1.5	3.5	4.9	8.5	11.1	9.4
Gems &	2.9	5.3	8.9	16.1	16.6	16.8
Petroleum	0.5	0.5	2.4	2.9	1.4	4.6
Others	0.3	0.6	3.6	1.7	1.8	6.9
Total Exports	18.1	31.8	52.7	100.0	100.0	100.0

Source: Quoted in RBI, *Report on Currency and Finance 2002-03*, p.89.

Notwithstanding the diversification of manufactured exports, the top ten export items of India account for about 60 percent of its total exports. Table 17.4 shows that USA is the main destination of all these products. Other major export markets are UK, Germany, France, Italy and Japan among the developed world whereas China, Hong Kong, UAE, Nigeria Taiwan, Bangladesh, Saudi Arabia, Turkey among the developing countries. Interestingly however, China and East Asian countries happen to be India's main competitors in those developed markets.

Table 17.4: India's Leading Exports

Commodity	Export share 1990-91	1995-96	2002-03	Destination	Major Competitors
Gems and Jewelry	16.1	16.6	16.8	USA(36.6) Hong Kong (19.2) Belgium(11.5)	Israel, Belgium, China (studs), Italy (plain gold) Thailand (gemstones)
Readymade Garments	12.3	11.6	10.2	USA(31.3), UK(8.9), Germany(7.7), UAE(7.0), France (6.8)	China, Korea, Taiwan, Indonesia, Thailand, Malaysia, Bangladesh

Basic Chemicals, Pharmaceuticals and Cosmetics	6.8	6.8	8.3	USA(14.1), Germany (5.6), China (4.4), UK(3.7), UAE(2.8)	China, Brazil (in castor oil)
Cotton Yarn, Fabrics, Made-ups etc.	6.4	8.1	6.2	USA(18.4), Korea(5.4), UK (4.7), Italy(4.6), Bangladesh(4.6)	China, USA, Australia (for yarn and made ups), China, Pakistan, Bangladesh (for fabrics)
Petroleum products	2.9	1.4	4.6	NA	NA
Machinery and Instruments	3.8	2.6	3.5	USA (13.9), Germany(7.5), UAE(6.8), UK (5.8), Nigeria(3.2)	Germany, Japan, Italy, China, Taiwan, Korea
Iron and Steel	0.9	2.2	3.4	China (27.5), USA(15.8), UAE(4.9), Bangladesh(3.7), Taiwan (3.5)	Indonesia, Korea, Malaysia, Australia, Brazil, South Africa
Manufactures of Metals	2.5	2.6	3.3	USA (23.6), UAE(10.8), UK(9.9), Germany(3.6)	Russia, South Africa, Korea
Marine Products	2.9	3.2	2.6	USA(27.9), Japan (22.6), China (7.6)	Indonesia, Thailand, Vietnam, Bangladesh
Man-made yarns, Fabrics, Made-ups etc.	1.2	2.4	2.5	UAE (19.7), Saudi Arab(5.3), Turkey(5.2), UK (4.7), USA (4.7)	Korea, China, Mexico, Bangladesh, Pakistan

Source: Same as in Table 17.3, p.90.

Note: Figures in parenthesis indicate the share of exports, as on 2002-03, directed to the respective countries in total exports of that commodity.

Another interesting feature of India's exports during 1990s has been that export products- iron and steel, petroleum products and pharmaceuticals gained both in terms of growth rate as well as share in the export basket. There were, on the other side, products such as tea, cotton, leather and readymade garments which found their shares declining in export markets (See Table 17.5).

Table 17.5: Major Export Gainers and Losers during the 1990s

Item	Share in India's Exports		% growth rate 1990-91 to 2002-03
	1990-91	2002-03	
Gainers			
Primary & Semi-finished Iron and Steel	0.6	3.0	25.2
Plastic & Linoleum	0.6	2.2	21.4
Manmade Yarn, Fabrics, Made-up etc.	1.3	2.5	15.8
Electronic Goods	1.3	2.2	14.1
Petroleum Products	2.9	4.6	13.6
Drugs, Pharmaceuticals & Fine Chemicals	3.1	4.7	13.1

Losers			
Cotton Raw including Waste	2.6	0.0	-27.7
Finished leather	5.2	0.9	-5.4
Tea	3.3	0.6	-4.7
Footwear of Leather	2.8	0.8	-1.7
Iron ore	3.2	1.6	3.3
Readymade Garments; Man- made Fibre	2.5	1.3	3.8

Source: Same as in Table 17.3, p.90.

@ Growth rate of exports in US dollar terms.

Note: In order to have reasonable comparative analysis, commodities having an export share of 2 percent or more during 2002-03 were taken to judge the top gainers. On the other hand only those items having an export share of 2 percent or more in 1990-91 were analysed so as to assess the loss of market shares.

Structure and composition of India's imports reveal many interesting features. First, the policy of trade liberalisation has blurred the distinction between essential imports and other imports in the wake of comfortable foreign exchange position.

Table 17.6: Structure of India's Imports

	% Share in Trade			% Share of Total Imports		
	1990-91	1995-96	2002-03	1990-91	1995-96	2002-03
Bulk Imports	10.8	14.3	24.1	45.1	39.0	39.3
Petroleum, crude oil and products	6.0	7.5	17.6	25.0	20.4	28.7
Bulk Consumption Goods	0.6	1.0	2.4	2.3	2.7	3.9
Edible oils	0.2	0.7	1.8	0.8	1.9	2.9
Other Bulk items	4.3	5.8	4.1	17.7	15.8	6.7
Fertilizers	1.0	1.7	0.6	4.1	4.6	1.0
Non Ferrous metals	0.6	0.9	0.6	2.6	2.5	1.0
Metalliferous ores, metal scrap, etc.	0.9	0.8	1.0	3.5	2.2	1.6
Iron and Steel	1.2	1.4	0.9	4.9	3.8	1.5
Non-Bulk imports	13.2	22.4	37.3	54.9	61.0	60.7
Capital Goods	5.8	10.3	12.7	24.2	28.1	20.8
Machinery except electrical and electronic	2.1	3.9	3.4	8.7	10.6	5.6
Electrical machinery except electronic	0.9	0.4	0.6	3.9	1.1	1.0
Electronic Goods	-	1.8	5.3	-	4.9	8.7
Transport equipment	0.9	1.1	1.8	3.9	3.0	2.9
Project Goods	1.4	2.4	0.5	5.9	6.5	0.8
Mainly Export Related items	3.7	5.3	10.2	15.3	14.4	16.7
Pearls, precious and semi-precious stones	2.1	2.1	6.0	8.7	5.7	9.9
Organic and inorganic chemicals	1.3	2.6	3.0	5.3	7.1	4.8
Others	3.7	6.8	14.3	15.4	18.5	23.3
Professional, scientific instruments, photographic	0.6	0.7	1.1	2.5	1.9	1.7
Coal, coke and briquettes, etc.	0.4	0.9	1.2	1.8	2.5	2.0
Total imports	24.1	36.7	61.4	100.0	100.0	100.0

Source: Same as in Table 17.3, p.99.

Table 17.6 shows that while petroleum still continues to have the top position in India's imports, capital goods, and others — mainly export related products have been the significant items of imports in the 1990s and beyond. Second, a glance at major sources of India's imports show that new import partners in

East Asia (mainly China) and Africa (South Africa) have come to occupy a prominent position in 2002-03. Belgium with a share of about 6 percent of India's imports remains stable throughout 1990s (See Table 17.7).

Table 17.7: Major Sources of India's Imports

Rank	Country	Share	Top Non-Oil products	Country	Share	Top Non-Oil products
		(%)	1990-91		(%)	2002-03
1.	USA	12.1	Machinery (except electrical and machine tools), Metal ferrous ores and metals scrap, fertilizer manufactures	USA	7.2	Electronic goods, Fertilizer manufactured, machinery (except electrical and electronics)
2.	Germany	8.0	Machinery (except electrical and machine tools), project goods, iron and steel	Belgium	6.1	Pearls, precious and semi-precious stones, transport equipments, machinery (except electrical and electronics)
3.	Japan	7.5	Machinery (except electrical and machine tools), project goods, iron and steel	China	4.5	Electronic goods, chemicals-organic and inorganic, textile yarns, Fabrics, Made up articles
4.	Saudi Arabia	6.7	Artificial resins, plastic materials etc. sculpture and unfrosted iron pits, organic chemicals	UK	4.5	Pearls, precious and semi-precious stones, non ferrous metals, machinery (except electrical and electronics)
5.	UK	6.7	Pearls, precious and semi-precious stones, machinery (except electrical and machine tools) project goods	Germany	3.9	Machinery (except electrical and machine tools), electronic goods, chemicals-organic and inorganic
6.	Belgium	6.3	Pearls, precious and semi-precious stones organic chemicals, iron and steel	Switzerland	3.8	Gold and silver, machinery (except electrical and electronics), organic chemicals
7.	CIS	5.9	Projects goods, non-ferrous metals, fertilizer manufactured	South Africa	3.4	Gold and silver, coal, coke and briquettes etc. chemicals-organic and inorganic
8.	UAE	4.4	Metaliferous ores and metals scrap, sulphur and unrosted iron pyres, inorganic chemicals	Japan	3.0	Machinery excluding electric and electronic goods, professional instruments (except electric), iron and steel
9.	Australia	3.4	Coal, coke and briquettes etc., Transport equipments, pulses	Korea	2.5	Electronic goods, machinery excluding electric and electronics, Transport equipments
10.	Singapore	3.3	Machinery (except electrical and machine tools), electrical machinery, transport equipments	Malaysia	2.4	Vegetable oil fixed (edible), electronic goods, wood and wood products
		64.3			41.3	

Source: Same as in Table 17.3, p.101.

Note: The share shown in the table is inclusive of petroleum, crude and products.

In the light of above, it can be said that the absolute value of India's foreign trade presently has reached a range of \$ 150-200 billion in 2005-06 from a level of not more than \$50 billion in 1991-92. India's exports have risen at a rate of over 20 percent per annum during 2002-05. Still India's overall trade position when compared to that of China seems pigmy. For example, China exported goods worth \$ 762 billion and imported goods around \$660 billion in the year 2005 alone, showing a massive trade surplus of \$102 billion in that year.

17.5 INDIA'S TRADE: STRATEGIC CONSIDERATIONS

17.5.1 Trade and Economic Growth

For a long time, academic debate on trade liberalisation and its positive effects on growth rate remained inconclusive and unsettled. But most recent studies suggest that trade liberalisation contributes to growth and that trade openness is an important factor behind higher productivity and per capita income. No doubt, trade openness in India has steadily improved i.e., foreign trade as a share of GDP rose from 13.32 percent in 1990-91 to 19.28 percent in 1995-96 and again 21.8 percent in 2000-01. While exports constituted 10.1 percent of GDP and imports 11.6 percent of GDP in 2000-01, the respective shares have maintained upward trend in the subsequent periods. The financing of India's imports from its export earnings nearly reached 87 percent in the second half of 1990s, implying the dependence on other sources of foreign exchange to finance its imports declined in the post-reform period.

Nonetheless, India's experience to open up its economy and contribution of trade to growth is hardly comparable to that of export-led industrialisation in East Asian countries. In the latter case, intra regional spill-over effects mainly originated from technology transfers through direct investment from Japan; each shift in the industrial focus of the Japanese economy created market opportunities for other economies in South Korea and Taiwan. Following specialisation in high-tech industries by South Korea and Taiwan, the light industries moved to Indonesia, Thailand and Philippines. Thus trade structure of East Asia remained manufacturing-centric and FDI in these countries was primarily directed to reduce technology gap.

Even based on the experience of East Asian countries, it may be difficult to separate the effect of trade openness on growth from other institutional mechanisms or policy reforms. Second, trade liberalisation is not sufficient for ensuring faster growth unless it is accompanied by other complementary policies such as monetary and fiscal policies and exchange rate policies. Whether exports contribute to economic growth, the outcome of a study conducted by RBI indicates that its contribution to GDP may be much lower when adjusted for import of raw materials.

"The contribution of exports adjusted for imports of raw material to their sales growth depicted a negative 0.3 percent during 1970s, which increased marginally to 1.5 percent during 1980s. However during 1990s, exports adjusted for import of raw materials to sales growth of these industries stood at 8.4 percent. This was mainly due to higher exports contribution of 12 percent during 1999-00/2000-01 (RBI, Report on Currency & Finance 2001-02, ch.vii, p.11). At best, we can say that due to higher annual average growth of exports in 1990s (12.9 percent) in relation to average GDP growth (6.1 percent), contribution of exports to growth in GDP increased modestly.

17.5.2 Trade-FDI Nexus

Economic liberalisation promotes both trade and FDI. The environment for trade and FDI has changed significantly since mid-1990s. The liberalisation of

rules and regulation governing trade, investment and technology flows has opened new opportunities, particularly in India's services sector. FDI could be export-promoting, import substituting or import enhancing depending upon supply and demand factors in the global economy. We usually do not look at direct magnitude of trade orientations of FDI but also its indirect effects-technological advancement, skill up-gradation, linkage effects with local firms, spillover and other related externalities, and reorientation of demand patterns.

Presently MNCs conduct a large proportion of world trade and have also become active in undertaking FDI. Though MNCs provide linkage between FDI and trade, determinants of this relationship (linkage) are mostly country-specific such as size of the local market, factor cost in the host market, locational advantage as also trade/investment restrictions in the host/home countries.

Available information suggests that the contribution of FDI to export expansion has been quite large for the ASEAN and China as they attracted mainly export-oriented FDI. For instance, foreign affiliates accounted for about half of total exports of China during 2002 and even higher in some high tech products. In case of India, exports as percent of value of total production of foreign investment companies has shown a marginal increase during 1990s. Rather import intensity of these companies remained marginally higher than their export intensity. (RBI, Report on Currency and Finance 2002-03).

As stated earlier, trade-linked FDI in services sector provide enormous scope for Indian exporters. Recently, Indian MNCs began seeking investment via cross-border M&A activities particularly in software industry in USA and UK. Due to technological advances in ICT (Information, Communication and Telecom), possibilities for export-oriented FDI in data processing, accounting and similar services have gone up tremendously (Medium Term Export Strategy 2002-07).

17.5.3 Trade in Services

You have already seen in Unit 13 how India has emerged as a major exporter of services, bringing about a change in our negotiating position at the WTO. India's trade in services, especially software exports have made a real dent in the world market. It ranked 18th largest services exporter with a share of 1.4 percent in global exports in 2003. An upward shift in trend growth of services exports from an average annual of 7.9 percent in the first half of 1990s to 15.3 percent in 2000-01/2003-04 reflect the growing volume of these exports in India's total exports. Traditionally while services receipts have been mainly from travel, transportation and insurance sub-sectors, more recently the buoyant growth of professional, technical and business services has provided a cushion against the slowdown in the former categories. These new economy services witnessed an average annual growth of about 37 percent during 1995-96/2003-04, contributing over 70 percent of total services exports in 2003-04. Software services export share alone rose from 10.2 percent in 1995-96 to 48.9 percent in 2003-04. Exports of software and IT-enabled services rose by about 28 percent in 2003-04 and further 34.4 percent to reach \$ 17.2 billion in 2004-05. The global market for software and services is projected to grow by 8.6 percent per annum during 2004-08. India remains an attractive source of software exports because of low cost of operations and availability of high

quality and skilled manpower resources. Another factor is that the structure of software services exports shows that financial services including banks, insurance companies and securities firms account for the largest share of Indian software services followed by manufacturing and telecom sectors.

17.5.4 Regional Trading Arrangements (RTAs)

You have seen in earlier Units that India has been playing an active role in WTO discussions. While Hong Kong WTO Ministerial has saved and kept the spirit of multilateralism alive, there have nevertheless been apprehensions first during Uruguay Round of Negotiations and subsequently during various Ministerial levels on the very viability of WTO as an institution of negotiations. However, one fall out of the stalled negotiations of Doha Round has been the emergence of RTAs. Whether these RTAs are building or stumbling blocs for multilateralism so far remains a moot point?

The relationship between regionalism, multilateralism (including globalisation) is an important issue of contemporary interest. For one thing, the global trading system has seen a sharp increase in regional trade agreements (RTAs) and presently over 300 RTAs have been notified to the WTO. About 90 percent of these RTAs are in the form of free trade areas (FTAs) and 10 percent customs union. As you learned in Unit 15, a free trade area involves abolition of tariffs while customs union imposes common external tariff in addition to abolition of tariffs among member countries. RTAs can be trade creating or trade diverting and can lead to welfare improvement or deterioration respectively. Arguments and counter-arguments exist whether unilateral tariff reductions are superior or inferior to granting regional preferential treatment. Some observers believe that proliferation of RTAs threatens or undermines the multilateral system while others opine that RTAs provide a push to global liberalisation in the present times.

The government of India signed various trade agreements with different countries of the world to enhance its trade volume. These trade agreements are of various forms like free trade agreements, preferential trade agreements etc. Free trade agreements aim at creating free trade zones by eliminating or reducing various tariffs and duties for imports of various contacting countries. Preferential trade agreements also extend such facilities to limited number of products. Sometimes trade agreements were made to give MFN status to contacting countries. India's trade agreement with Mongolia is one such case. In some cases the contacting countries sign framework agreements to start negotiation for such trade agreements. Often these trade agreements are supplemented with early harvesting programme, which puts selected commodities on a 'fast track' for liberalisation. Table 17.8 gives the list of India's trade agreements with different countries and regional trading blocks after 1990. India has been a member of SAARC Preferential Trading Agreement (now South Asian Free Trade Area from 1 January 2006). Besides, India is member of Indian Ocean Rim Association of Regional Cooperation Agreement, BIMST-EC (Bangladesh, India, Myanmar, Sri Lanka, Thailand Economic Cooperation). India has also entered bilateral free trade agreements with Sri Lanka, Thailand and a Framework Agreement for Comprehensive Economic Cooperation between India and ASEAN members.

Table 17.8: Trade Agreements of India with Different Countries since 1990

**Indian Trade Policy:
Historical Perspective
and Recent Developments**

Free Trade Agreements/ Preferential Trade Agreements/ Regional Trade Agreements	Date Signed	Partner Countries
Indo-Sri Lanka Free Trade Agreement	28-Dec-98	India, Sri Lanka
India-Afghanistan Preferential Trade Agreement	6-May-03	India-Afghanistan
India-Singapore Comprehensive Economic Cooperation Agreement	29-Jun-05	India-Singapore
Framework agreement with Chile	20-Jan-05	India-Chile
India- Thailand Framework Agreement for Free Trade Area	10/9/2003 (amended on 30 August 2004)	India-Thailand
India- Mongolia Agreement on Trade and Economic Cooperation	16-Sep-96	India-Mongolia
India-Bangladesh Trade Agreement	4-Oct-1980 (Renewed from time to time and now valid up to 30 October 2001)	India-Bangladesh
Indo-Nepal Treaty of Trade	6-Dec-91	India-Nepal
Framework Agreement on India-Egypt Preferential Trade Area	30-Apr-01	India-Egypt
Free Trade Agreement on Trade and Commerce	28-Feb-95	India-Bhutan
Framework Agreement for Comprehensive Economic Cooperation between India and ASEAN Nations	8-Oct-03	India- Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam
India-MERCOSUR Preferential Trade Agreement	25-Jan-04	India- Argentina, Brazil, Paraguay, Uruguay
India- GCC Framework Agreement on Economic Cooperation	25-Aug-04	India-UAE, Bahrain, Saudi Arabia, Oman, Qatar, Kuwait
Framework Agreement on BIMST Economic Cooperation FTA	8-Feb-04	Bhutan, India, Myanmar, Nepal, Sri Lanka, Thailand
Bangkok Agreement	31 July 1975 (latest negotiation in October 2001)	Presently operational between five countries: Bangladesh, China, India, Republic of Korea and Sri Lanka
Agreement on SAARC Preferential Trading Arrangement (SAPTA)	11 April 1993	Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka
Agreement on South Asian Free Trade Area (SAFTA)	06 January 2004	Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka

Check Your Progress 3

- 1) Do you think there is some change in the composition and direction of India's foreign trade in post-reform period?

.....

.....

.....

.....

- 2) "Trade-FDI nexus has not succeeded in India as much as in East Asia" Comment.

.....

.....

.....

3) How do you assess trade's contribution to economic growth in India?

.....

.....

.....

.....

4) What are the current issues concerning India in WTO? Are multilateralism and regionalism compatible?

.....

.....

.....

.....

17.6 LET US SUM UP

We are now in a position to sum up our analysis of India's trade policy. First, India's trade policy has always been very intricately related to India's basic development goals of achieving high rate of GDP growth and the removal of poverty. Since India was specialised in primary production and therefore exports of primary products during the early years of our planning for industrialisation, India followed a very restrictive import control regime since the second five year plan. Such policies had resulted in a very slow growth in output and India's share in the world trade has been continuously declining. There was however increasing realisation of the fact that protectionist policies had led to growing industrial inefficiency resulting in slow growth performance. The economic crisis of 1991 and the remarkable economic performance of the East Asian countries and the Chinese economy, which have followed vigorous export oriented strategy of growth by liberalising their economies compelled Indian policy makers to initiate fundamental reform measures in India also. India has liberalised its economy in many dimensions and particularly it has liberalised its trading sector by eliminating all quotas and also progressively reducing the tariffs. These measures have resulted in higher growth performance and rapid transformation of the economy.

17.7 KEY WORDS

Canalised Items: Canalised items are those items that could only be imported through a designated state trading agency. This category of items was included in the list of India's imports before liberalisation in 1991. India's imports at that time were divided into four categories — open general license or OGL items, restricted items, prohibited items and canalised items. OGL items meant no license was required, restricted items meant an import license was required for them to be imported, prohibited items were banned and canalised items could only be imported through a designated state trading agency.

Foreign Direct Investment (FDI): FDI inflow or outflows are with the intention of buying physical assets to start a business in the home country or abroad on long term basis.

Measure of Openness: It is a ratio of Trade to Gross Domestic Product (Trade/GDP)

**Indian Trade Policy:
Historical Perspective
and Recent Developments**

Quantitative Restrictions (QRs): QRs are quotas on the physical amounts of particular commodities that can be imported or exported during a specified time period and are usually measured by volume or sometimes by value.

17.8 SOME USEFUL REFERENCES

Agarwal, Manmohan, The Role of the External Sector in India's Development Strategy: Implications for MTN, in John Whalley Ed. *Developing Countries and the Global Trading System*, vol. 2 Macmillan, PP. 101 – 120.

Centre for Monitoring Indian Economy (CMIE). 2005. *Foreign Trade and Balance of Payments*, July, Bombay.

External Sector of India, Economic Survey (Various Issues), Government of India.

GOI. 2004-05. *Economic Survey*, Government of India, Ministry of Finance, New Delhi.

GOI. 2002. *Medium Term Export Strategy 2002-07*, Government of India, Ministry of Commerce and Industry Department of Commerce, New Delhi.

GOI. 2004. *Foreign Trade Policy 2004-09*, Government of India, Ministry of Commerce and Industry, Department of Commerce, New Delhi.

Kenen, Peter B. 1994. *The International Economy*, 3rd Edition, Cambridge University Press, Ch. 9 – 11, PP. 185 -297.

Reserve Bank of India. 2005. *Report on Currency and Finance 2001-02*, Chapter VII (External Sector), Bombay.

17.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

- 1) Read Section 17.2
- 2) Read Section 17.2
- 3) Read Section 17.2

Check Your Progress 2

- 1) Read Section 17.3
- 2) Read Sub-section 17.3.1
- 3) Read Sub-section 17.3.2
- 4) Read Sub-section 17.3.3

Check Your Progress 3

- 1) Read Sub-section 17.4.3
- 2) Read Sub-section 17.5.2
- 3) Read Sub-section 17.5.1
- 4) Read Sub-section 17.5.4

UNIT 18 INDIA'S BALANCE OF PAYMENTS

Structure

- 18.0 Objectives
- 18.1 Introduction
- 18.2 Explaining Balance of Payments Crisis in Early 1990s
- 18.3 Components of Balance of Payments
 - 18.3.1 BOP on Current Account
 - 18.3.2 BOP on Capital Account
- 18.4 Trends in Current Account
- 18.5 Trends in Capital Account
- 18.6 Determinants of Balance of Payments
- 18.7 Issues Related to Balance of Payments
 - 18.7.1 Sustainability of Current Account Deficit
 - 18.7.2 Liberalisation of Capital Account and Convertibility Issue
- 18.8 Let Us Sum Up
- 18.9 Key Words
- 18.10 Some Useful References
- 18.11 Answers/Hints to Check Your Progress Exercises

18.0 OBJECTIVES

This Unit provides an overview of India's balance of payments and patterns of changes since 1991. After going through this Unit, you will be able to:

- distinguish Balance of Payment crisis in 1991 from earlier such crises;
- understand the need for BOP policy changes in post-reform period;
- analyse and understand the BOP statements;
- identify the determinants of BOP;
- assess the impact of pattern of changes on overall BOP; and
- evaluate major components of BOP and some of their strategic considerations.

18.1 INTRODUCTION

The Balance of Payment crisis in India in 1991 was a watershed in its economic history, which led to far-reaching economic reforms subsequently and a host of policy changes in its industrial, trade, financial, labour and agriculture sectors. The avowed objective of policy reforms was to open up the Indian economy to gain competitiveness, efficiency and higher productivity and to integrate it with the world economy. While the BOP crises have been recurring phenomena from time to time during the first four decades of India's planned economic development, strategies to deal with those crises were mostly conceived in terms of our old development model of import substitution industrialisation till early 1980s. The 1991 crisis, however, marked a complete shift in our development strategy and with that its impact on various sectors including our external sector has remained quite profound.

18.2 EXPLAINING BALANCE OF PAYMENTS CRISIS IN EARLY 1990s

immediate Gulf crisis alone but its steady build-up can be traced to a series of external shocks and domestic failures in 1980s. **First**, with the second oil shock of 1979-80 and doubling of India's import bill along with dismal export performance as a result of severe world-wide recession resulted into current account deficit of 1.8 percent of GDP, and adjustment was made possible through IMF Extended Fund Facility with a massive loan of \$5.7 billion in 1981. **Second**, strains on BOP again resurfaced during 1985-90. Rising exports but much faster increasing imports and declining support from invisible receipts (due to growing interest payments and outgo on account of profits, dividends, royalties and technical fees) caused the current account deficit to reach 2.4 percent of GDP during this period. **Third**, domestic fiscal deficit rose from an annual average of 6.3 percent in 1980-84 to 8.2 percent of GDP in 1985-90. While external assistance, commercial borrowings and NRI deposits did finance the 'twin deficits' yet it was at a high cost of doubling India's external debt and rising debt service ratio i.e., from 13.6 percent in 1984-85 to 30 percent of export earnings in 1989-90. **Fourth**, superimposed on 1980s 'twin deficits' was the Gulf crisis of 1990 which marked a massive rise in oil price, decline in workers' remittances and additional cost of repatriation of expatriates, thus causing the current account deficit to reach \$9.7 billion in 1990-91, a higher figure of \$2.8 billion from the previous year. **Fifth**, financing of this deficit was an uphill task as foreign currency assets had reached a very low point; recourse to commercial borrowings dried up thanks to India's downgrading by credit rating agencies; outflow of NRIs deposits remained unabated and short term credit was denied rollover by lenders. The only option left was to seek IMF assistance and avoid debt default. **Sixth**, potent reasons for economic policy changes were not related only to the immediate and unprecedented crisis but also to growing realisation that our development strategy since 1950 and concomitant regulatory frame had failed miserably. **Seventh**, earlier liberalisation attempts touched irritants like control, licensing and regulatory regimes at the margin unlike all pervasive economic reforms witnessed in post-1991 period. These reforms were conceived as a package of mutually supporting and consistent elements and called for coordinated action in several areas.

18.3 COMPONENTS OF BALANCE OF PAYMENTS

Broadly speaking, as you learned in Unit 7, BOP is a statement that summarises all the economic transactions between residents (individuals, companies and other organisations) of the home country and those of all other countries. BOP accounting uses the system of double-entry book-keeping meaning thereby that every debit and credit in the account is also represented as a credit or debit somewhere else. Current Account and Capital Account are the two most important components of BOP. The following is a brief review of the concepts. Please consult Unit 7 for more details.

18.3.1 BOP on Current Account

BOP on Current Account records flows of goods and services, and unilateral transfers such as gifts. The merchandise trade account is a major part of BOP for most countries. If merchandise exports of a country exceeds its merchandise imports, the country is said to have favourable balance of trade.

Conversely, if imports exceeds exports, an unfavourable balance of trade arises. In short, the difference between such exports and imports is termed as trade balance.

Non-merchandise items are known as invisibles. These are sub-divided into services, investment income and transfer payments. Services include travel and tourism, transportation, financial, insurance, government and a variety of miscellaneous services. For instance, India's software services have recently been the fastest growing services exports. Investment income refers to receipts and payments of dividends, interest and profit arising out of Indian investment abroad and foreign investment in India. Transfer payments usually are in the nature of foreign aid, grants, gifts and foreign workers' remittances to their home countries. NRI's remittances are significant component of transfer payments in India.

18.3.2 BOP on Capital Account

BOP on Capital Account shows only export and import of capital and the difference between the two represents a country's capital account balance. Capital account is important because movements in capital decides the sustainability of current account deficit as well as exchange rate trends. In India, capital inflows or outflows mainly take place in the form of FDI and portfolio investment, commercial loans and banking capital (NRI deposits including). FDI inflows or outflows are with the intention of buying physical assets to start a business in the home country or abroad on long term basis. Portfolio investment with a view to buying financial assets in securities markets and NRI deposits/withdrawal show short-term capital movement. External commercial borrowings are undertaken both by government and private sectors from bilateral, multilateral and private sources either on short or long term basis. Banking capital records changes in foreign assets and liabilities of the Indian banks authorised to deal in foreign exchange. Capital inflows increase the banks' liabilities (credit item) while outflows are their assets and enter debit items in their accounts. Further two minor items — rupee debt service to repay foreign debt in rupees and other capital accruing on account of delayed receipts of exports — are part of capital account. After adjusting for errors and omissions we get an overall balance, which is nothing but sum of current and capital account transactions. Under IMF transactions, loans from that organisation are a credit item while repayments are a debit entry in our books. Drawing down from and accretion to foreign exchange reserves act balancing entry to meet deficit or show surplus respectively elsewhere in BOP. Putting all the entries together, it is to be remembered that the "Balance of Payments always Balances". A related question is about BOP Equilibrium which requires that any deficit on the current account be matched by an equal surplus on the capital account and vice-versa.

18.4 TRENDS IN CURRENT ACCOUNT

Having discussed the various items of current and capital accounts in BOP, we shall now analyse the trend behaviour of these items since 1991.

Table 18.1: Balance of Payments – Key Indicators

Item/Indicator 1	2004-05 (P) 2	2003-04 3	2002-03 4	2001-02 5	2000-01 6	1999-00 7	1990-91 8
i) Trade Balance	-38,130	-15,454	-10,690	-11,574	-12,460	-17841	-9,437
ii) Invisibles, net	31,699	26,015	17,035	14,794	9,794	13143	-243
iii) Current Account Balance	-6,431	10,561	6,345	3,400	-2,666	-4698	-9,680
iv) Capital Account	32,175	20,542	10,840	8,551	8,840	10444	7,056
v) Overall Balance #	26,159	31,421	16,985	11,757	5,868	6402	-2,492
vi) Foreign Exchange Reserves* Increase(-)/Decrease(+)	-26,159	-31,421	-16,985	-11,757	-5,842	-6142	1,278
Indicators (in per cent)							
1. Trade							
i) Exports/ GDP	11.7	10.8	10.6	9.4	9.9	8.4	5.8
ii) Imports/ GDP	17.2	13.3	12.7	11.8	12.7	12.4	8.8
iii) Export Volume Growth	n.a.	6.0	21.7	3.9	23.9	15.5	11.0
2. Invisibles							
i) Invisible Receipts/ GDP	11.2	8.8	8.2	7.7	7.1	6.8	2.4
ii) Invisible Payments/ GDP	6.6	4.5	4.9	4.6	4.9	3.8	2.4
iii) Invisibles (Net)/ GDP	4.6	4.3	3.3	3.1	2.2	2.9	-0.1
3. Current Account							
i) Current Receipts @/ GDP	22.8	19.5	18.7	17.0	17.0	15.1	8.0
ii) Current Receipts Growth@	34.6	23.0	17.6	4.5	14.8	12.9	6.6
iii) Current Receipts @/ Current payment	95.7	109.3	106.6	103.8	96.4	93.0	71.5
iv) Current Account Balance/GDP	-0.9	1.7	1.2	0.7	-0.6	-1.0	-3.1
4. Capital Account							
i) Foreign Investment / GDP	2.1	2.7	1.2	1.7	1.5	1.2	0.0
ii) Foreign Investment/ Exports	17.9	24.8	11.2	18.2	14.9	13.8	0.6
5. Others							
i) Debt –GDP Ratio	17.4	17.8	20.3	21.2	22.6	22.1	28.7
ii) Debt Service Ratio	6.2	16.3	16.4	13.4	16.6	16.2	35.3
iii) Liability Service Ratio	17.1	17.1	16.1	14.9	18.4	17.0	35.6
iv) Import Cover of Reserves (in months)	14.3	16.9	14.2	11.5	8.8	8.2	2.5

P: Preliminary # : Includes errors and omissions. @ : Excluding Official transfers.

: Excluding valuation changes. n.a. : Not available

Source: RBI Annual Report 2004-05 (Bombay), p.75

Table 18.1 summarises the key indicators of BOP both in absolute and relative terms. Despite the fact that both exports and imports have been growing at a faster rate in post-liberalisation era, trade deficit has also been on the rise. From \$ 9437 million in 1990-91, the trade deficit rose to \$11359 million in 1995-96 and \$17841 million in 1999-00. In the following three years however, it had shown a decelerating trend reaching a low figure of \$10690 million in 2002-03. Nonetheless, after showing a massive jump of nearly 50 percent in 2003-04, trade deficit rose to a staggering \$38130 million — about 150 percent in 2004-05 over the previous year. Preliminary estimates suggest that the same is likely to reach \$ 45 billion in 2005-06. This massive deficit has been a concern area for the government.

A glance at the net invisible account suggests that its ever-rising trend from 2000-01 did not only support the massive trade deficit but also could reduce the current account deficit in 1999-00 and 2000-01. Surprisingly, the continued rise in invisibles led current account to register surplus during 2001-02/2003-04. Deterioration in current account deficit has started from 2004-05 onwards largely on account of burgeoning trade deficit. Although somewhat erratic trend was witnessed in capital account balance during 1990s, it maintained upward movement in the new millennium leading to overall balance surplus and voluminous foreign exchange reserves.

In relative terms, merchandise-trade GDP ratio has nearly doubled i.e., from 14.6 percent in 1990-91 to 28.9 percent in 2004-05. India's share in world exports also spurted to 0.84 percent in 2004 from 0.52 percent in 1990. Invisible receipts/GDP ratio from a low of 2.4 percent in 1990-91 reached 7.7 percent in 2001-02 and further rose to 11.2 percent in 2004-05. Another indicator current receipts as a proportion of current payments rose from 71.5 percent in 1990-91 to 96.4 percent in 2000-01; exceeded 100 percent in 2001-02/2003-04 but fell to 95.7 percent in 2004-05. The most worrisome current account deficit/ GDP ratio which had worsened to 3.1 percent in 1990-91 improved considerably during 1990s and was hardly 0.6 percent in 2000-01. Subsequently, a sustained rise in net invisible surplus turned the current account into surplus rising from 0.7 percent of GDP in 2001-02 to 1.2 percent in 2002-03 percent and 1.7 percent in 2003-04. However in 2004-05, current account deficit as a proportion of GDP reached 0.9 percent and is likely to maintain the same trend in 2005-06, particularly on account of massive trade deficit. There has been considerable improvement in debt and debt service ratios over the 1990s and India has gained a high degree of credit-worthiness in the world economy.

Table 18.2 exhibits invisible items by category of transactions during 2001-2/2004-05. While non-factor services have shown some erratic trend, these nevertheless registered a massive surplus in 2004-05. Exports of software and related services doubled from 2000-01 level to reach \$12.8 billion in 2003-04 and a massive \$17.2 billion in 2004-05. Liberalisation of travel abroad has put the net receipts from travel in the red in 2004-05. The deficit in investment income is on account of repayments of debt and profits & dividend payments. Not surprisingly, private transfers (NRIs remittances) net balance showing a larger chunk of the net invisibles during all these years. In 2005-06, an estimated \$25 billion is expected on this account.

Table 18.2: Invisibles by Category of Transactions

(US \$ Million)

Item / Year	2004-05 (P)	2003-04 (R)	2002-03	2001-02
I. Non Factor Services, net	14,630	6,591	3,643	4,577
Receipts	51,326	24,949	20,763	20,665
Payments	36,696	18,358	17,120	16,088
Travel, net	-497	611	-29	628
Receipts	5,029	4,122	3,312	2,910
Payment	5,526	3,511	3,341	2,282
Transportation, net	509	929	-736	-413
Receipts	5,048	3,260	2,536	1,969
Payment	4,539	2,331	3,272	2,382
Insurance, net	294	57	19	13
Receipts	1,016	420	369	267
Payments	722	363	350	254
G.N.I.E., net	142	70	65	197
Receipts	403	282	293	469
Payments	261	212	228	272
Miscellaneous, net	14,182	4,924	4,324	4,152
Receipts	39,830	16,865	14,253	15,050
Payments	25,648	11,941	9,929	10,898
II. Investment Income, net	-3979	-3,972	-3,446	-3,601
Receipts	4,694	4,287	3,522	3,448
Payment	8,673	8,259	6,968	7,049
III. Private Transfers, net	20,459	22,833	16,387	12,125
Receipts	20,859	23,183	17,189	12,192
Payment	400	350	802	67
IV. Official Transfers, net	589	563	451	384
Receipts	621	563	451	385
Payments	32	0	0	1
V. Invisibles, net (I to IV)	31,699	26,015	17,035	13,485
Receipts	77,500	52,982	41,925	36,690
Payments	45,801	26,967	24,890	23,205

P: Provisional. R: Revised GNIE: Government, Not Included Elsewhere.

Source: Same as in Table 18.1, p.284

Check Your Progress 1

- 1) What led to India's BOP crisis in early 1990s? How did we overcome the crisis situation?

.....

.....

.....

.....

- 2) Show your familiarity with visible and invisible items on current account. What does it mean "BOP always balances"?

.....

.....

- 3) Distinguish between current account and capital account transactions in a country's BOP.

18.5 TRENDS IN CAPITAL ACCOUNT

Having highlighted the trends in current account, it is equally important to observe the behaviour of capital account transactions.

Table 18.3: Composition of Capital Inflows

(US \$ Million)

Item / Year	2004-05P	2003-04 R	2002-03	2001-02	2000-01	1995-96	1990-91
Total Capital Inflows (Net)	32175	20542	10840	8551	8840	4089	7056
<i>Of Which :</i>	<i>(in per cent)</i>						
1. Non Debt Creating Inflows	44.9	78.2	55.5	95.2	76.8	117.5	1.5
a) Foreign Direct Investment **	17.2	22.8	46.5	71.6	45.6	52.4	1.4
b) Portfolio Investment	27.7	55.4	9.0	23.6	31.2	65.1	0.1
	28.8	2.1	-12.3	12.3	78.8	57.7	83.3
	6.3	-13.3	-28.6	14.1	4.8	21.6	31.3
2. Debt Creating Inflows	15.3	-7.4	-15.7	-18.6	48.6	31.2	31.9
a) External Assistance	11.8	6.9	8.9	-9.3	6.2	1.2	15.2
b) External Commercial Borrowings #	-3.3	17.7	27.5	32.2	26.2	27.0	21.8
c) Short term Credits	-1.3	-1.8	-4.4	-6.1	-7.0	-23.3	-16.9
d) NRI Deposits \$	26.3	19.7	56.8	-7.5	-55.6	-75.2	15.2
c) Rupee Debt Service							
	100.0	100.0	100.0	100.0	100.0	100.0	100.0
3. Other Capital @							
4. Total (1 to 3)							
Memo Item :							
Stable flows +	60.5	37.7	82.0	85.7	62.5	33.7	84.7

P : Provisional R : Revised

** : Data on FDI have been revised since 2000-01 with expanded coverage to approach international best practices. FDI data for previous years would to medium and long-term borrowings.

: Refers to medium and long-term borrowings.

\$: Including NR (NR) Rupee Deposits.

@ : Includes leads and lags in exports (difference between the custom and the banking channel data), Banking Capital (assets and liabilities of Banks excluding NRI deposits), loans to non-residents by residents, Indian investment abroad and India's subscription to International Institutions and quota payments to IMF.

+ : Stable flows are defined to represent all capital flows excluding portfolio flows and short-term trade credits.

Source : Same as Table 18.1, p. 285

Table 18.3 provides a bird's eye view on composition of capital inflows during 1990-91/2004-05. While total capital inflows on net basis rose nearly eight-fold i.e., from \$4089 million in 1995-96 to \$32175 million in 2004-05, it is the relative importance of non-debt creating inflows in the total inflows. FDI inflows averaged more than 50 percent of these inflows between 2000-01 and 2002-03 and since then this share has averaged about 20 percent. Foreign investment/GDP ratio reached 2.1 percent in 2004-05 from almost nil in 1990-91. Most recently, portfolio investment in 2004-06 exceeded considerably the FDI volume. Among the debt creating inflows, external commercial borrowings and short term credits have shown an upward movement. It may be remembered that portfolio investment and short term credits are characterised as unstable flows and hence need a careful watch from time to time.

Table 18.4 gives us an idea of investment flows. From 2003-04 onwards, portfolio investment has been continuously on the rise and its level has been nearly double that of FDI. High GDP and industrial growth rates, booming external sector and above all stable policy regime have attracted foreign institutional investors to raise their stake in India.

Table 18.4: Foreign Investment Flows to India

(US \$ million)

Item / Year	2004-05(P)	2003-04	2002-03	2001-02
A. Direct Investment (I+II+III)	5,536	4,673	5,035	6,131
I. Equity (a+b+c+d+e)	3,363	2,387	2,764	4,095
a) Government (SLA/FIPB)	1,062	928	919	2,221
b) RBI	1,259	534	739	767
c) NRI	-	-	-	35
d) Acquisition of shares*	930	735	916	881
e) Equity capital of unincorporated bodies	112	190	190	191
II. Re-invested earnings	1,816	1,798	1,833	1,646
III. Other capital #	357	488	438	390
B. Portfolio Investment (a+b+c)	8,909	11,377	979	2,021
a) GDRs/ADRs	613	459	600	477
b) FIIs @	8,280	10,918	377	1,505
c) Off-shore funds and others	16	-	2	39
C. Total (A+B)	14,445	16,050	6,014	8,152

P : Provisional

- : Nil/Negligible.

* : Relates to acquisition of shares of Indian companies by non-residents under Section 6 of FEMA 1999.

: Data pertain to inter-company debt transactions of FDI entities.

@ : Data represent net inflow of funds by FIIs.

Source : Same as Table 18.1, p. 81

Note : 1. Data on reinvested earnings for 2003-04 and 2004-05 are estimates.

2. Data on foreign investment present in this table represent inflows into the country and may not tally with the data presented in other tables. They may also differ from data relating to net investment in stock exchanges by FIIs.

Table 18.5 indicates the continuous rise of foreign exchange reserves since 1996. With more than \$141 billion of these reserves at end-March 2005, India ranked sixth in the world and our import cover of these reserves reached 14.3 months as against 2.5 months in 1990-91. A large part of these reserves

(90 percent) is in the form of foreign currency assets and gold. The primary objectives of these reserves have been to preserve their long term value and adequacy to meet contingencies arising out of payment difficulties or sudden reversal of capital inflows.

Table 18.5: Foreign Exchange Reserves

As at end of March	Gold	SDR	Foreign Currency Assets	Reserve Position in the IMF	Total	Use of IMF Credit
1993	3380	18	6,434	396	10,128	4,799
1994	4078	108	15,068	299	19,553	5,040
1995	4370	7	20,809	331	25,517	4,300
1996	4,56,182	17,044	310	21,997	2,374	
1997	4,054	2,22,367	291	26,714	1,313	
1998	3,391	1,25,975	283	29,650	664	
1999	2,960	8,29,522	663	33,153	287	
2000	2,974	4,35,058	658	38,694	26	
2001	2,725	2,39,554	616	42,897	0	
2002	3,047	10	51,049	610	54,716	0
2003	3,534	4,71,890	672	76,100	0	
2004	4,198	21,01,448	1,311	1,12,959	0	
2005	4,500	51,35,571	1,438	1,41,514	0	

Source : Same as in Table 18.1, p.87

For the past six years, India has not used IMF credit and thus our reserve position has improved considerably. Rather, IMF designated India as a creditor country under its Financial Transaction Plan (FTP) in early 2003 and its total lending under this Plan amounted to \$561.3 million with a view to provide financial support to Burundi, Brazil and Indonesia in the same year.

18.6 DETERMINANTS OF BALANCE OF PAYMENTS

Broadly speaking, trend behaviour of merchandise exports and imports along with their terms of trade, net invisible earnings and autonomous capital inflows affects a country's BOP. Each one of these variables is a stimulus to growth and determines the long term viability of external sector. **First**, exports hold the key to achieving a sustainable balance between the requirements of higher growth and of ensuring viability in the external sector. As a determinant, the higher the share of exports in a country's GDP, faster will be the growth of the economy in response to an increase in overseas demand. **Second**, imports are a positive function of GDP. An intrinsic link between merchandise imports and exports leads to vigorous export growth and high level of GDP. However as expected, import price is negatively related to its volume. **Third**, among the items of net invisible earnings, a steady and continuous flow of remittances (insensitive to interest rate) does have a positive effect to sustain a high level of trade deficit. Examples of India, Turkey and Philippines are a pointer in this direction. **Fourth**, services exports hinge on the degree of association and direction of causality between service orientation of the output structure and the share of services in international trade (RBI, Report on Currency and Finance 2002-03, p.133). **Fifth**, steady foreign investment inflows are promised to support the investment needs of the economy for higher growth and a source of prudent debt management. For,

refinancing of costly debts and prepayment of identified high cost debt in external debt management will have a positive impact on BOP capital account.

18.7 ISSUES RELATED TO BALANCE OF PAYMENTS

It is to be remembered that the Indian economy witnessed varying intensities of BOP problem during 1956-91. However over the 1990s, India's BOP position improved considerably coinciding with liberalisation of overall external sector. No doubt, this improvement can be visualised in the context of changing composition of BOP during this period. For instance, massive trade deficit has been and continues to be sustained with rising invisible receipts; non-debt flows have generally exceeded the debt flows and liquidity risk has been managed with different types of flows. During this period much attention has also been paid to current account sustainability. Also, issues related to capital account liberalisation and its convertibility have been under close scrutiny by high-powered Expert Committees. While these aspects of our BOP merit detailed discussions, it is important to mention here two important features of India's BOP on current account.

First, India's medium term current account surplus (2001-02/2003-04) has been structurally different from those of many other developing countries. Since for most of those countries it is their merchandise trade account surplus reflecting high merchandise export growth. But India's current account surplus was largely on account of services receipts as the trade account recorded a deficit of the order of an average of 2.8 percent of GDP during the same period. **Second**, the resurgence of current account deficit in the subsequent years indicates an end of a period of export of domestic savings and resumption of the role of foreign savings in financing higher investment and growth in the economy. Rather on the contrary, developing countries such as China, South Korea, Malaysia, Thailand, Indonesia, Argentina and Brazil continued to record current account surpluses reflecting the counterpart of massive current account deficit of USA.

18.7.1 Sustainability of Current Account Deficit

Theoretically speaking, a current account deficit can be sustained as long as the growth rate of national income exceeds the rate of interest on the nation's liabilities. Sufficient condition for sustainability of this deficit is a constant foreign debt – GDP ratio over a time period. In the reverse gear, non-sustainability implies (a) large current account deficit – GDP ratio (b) persistent low domestic savings rate on account of current account imbalance.

Implications and effects of persistent current account deficit are far and wide. For, foreign investors may take a pessimistic view of country's ability to meet its foreign obligations and even reduce the capital inflows. **Second**, a current account deficit represents an imbalance between demand for and supply of foreign exchange as a result of which there might be speculative attack on the currency, fraught with serious consequences for the whole economy. **Third**, if caused primarily by widening trade deficit, a current account imbalance indicates structural competitiveness problem. Such a structural constraint is

reflected in lower export – GDP ratio and continuous higher import – GDP ratio. **Fourth**, it has been empirically observed that high current account deficits are at the bottom of external payments crisis worldwide. A bench-mark suggests that a current account deficit (CAD) GDP ratio of 5 percent should be a cause for concern from the viewpoint of its sustainability. **Fifth**, the size, composition as well as financing of the current account deficit is critical in determining the future sustainability sector. This becomes even more important when with the relaxing barriers to capital mobility, current account deficit can increase vulnerability of these economies to external shocks. The Mexican peso crisis of 1994-95, the East Asian currency turmoil of 1997, the Russian and Brazilian crisis of 1998-98 and that of Argentina of 2001-02 are reminder of the vulnerability of these economies to massive build-up of current account imbalances non-sustainability and proved disastrous for their financial stability.

In India, the issue of a sustainable current account deficit assumed crucial significance in the aftermath of 1990-91 crisis. A current account deficit of 3 percent of GDP triggered a crisis in India in the same year. It was argued in some quarters that a distinct decline in invisible earnings during 1985-90 was a key factor in precipitating the crisis of 1990-91. In terms of the size of the current account deficit, its range of 1.5 to 2.5 percent of GDP has been considered consistent with the stabilisation of India's net external liabilities. Further, the High Level Committee on BOP (Chaired by C. Rangarajan) recommended a CAD/ GDP ratio of 1.6 percent. Similarly, the document on Tenth Five year plan (2002-07) projects a current account deficit of 1.6 percent of GDP as against 0.9 percent of GDP in the Ninth Plan. This deficit was consistent with macro variables of domestic savings, investment and incremental capital output-ratio to achieve a growth rate of 8 over the plan period.

What has been the experience of India in post reform period? Has current account deficit been consistent with macro variables and its projections during 1990s and beyond? These aspects merit some consideration.

As against many developing countries, the Indian experience turns out to be different from those countries with its high saving-investment correlation and low capital mobility (RBI, *Report on Currency and Finance 2002-03* p. 132). Following RBI analysis, it can be said that a high positive saving – investment gap of the private sector was a reflection of stagnation in investment demand during a large part of 1990s. The negative public sector saving investment gap in India seems to have been adjusted within the economy without spilling over to the external sector. And thus despite massive fiscal deficit, India's current account deficit has remained insulated by rising private savings.

Another innovative operational rule to manage current account deficit in India has evolved around the fact that CAD/ GDP ratio could be adjusted in consonance with the rate of growth of current receipts, rather than stick to merchandise export growth. Simply stated, higher the ratio of current receipts to GDP, the higher is CAD/ GDP ratio that can be sustained given a desired level of debt service ratio. For this, one of the contributing factors has been the rise in invisible earnings from increasing tradability and competitiveness of services in India. Second, emergence of workers remittances has proved an

important source of external finance, offsetting high trade deficit and volatility in capital account. Third, it is also recognised that potential exports of services under Mode 4 can contribute significantly to an enduring current account sustainability in India.

18.7.2 Liberalisation of Capital Account and Convertibility Issue

Broadly speaking and irrespective of sector specificity, a liberalised system is one where the role of the government has been curtailed and the system is governed by market forces. In BOP on capital account, liberalisation implies removal/ relaxation of controls/restraints on capital account transactions. This also indicates a move towards free currency convertibility.

With the astronomical growth of private capital flows at the global level along with its attendant risk of flight capital, the issue of capital account convertibility has remained much focused in several countries. A series of currency crises in Europe, Mexico East Asia Russia Brazil, Turkey and Argentina, as mentioned earlier, raised a pertinent question even about the desirability of capital account liberalisation and fuller convertibility.

Nonetheless, based on the international experience, it is more or less agreed now that the pre-conditions for liberalised capital account are strong domestic financial system and sound macroeconomic policies and appropriately conceived phase out period of such liberalisation. In terms of sequencing, liberalisation of capital account should follow the current account.

India faced BOP crisis in 1990-91. While the short- term policy response was an IMF policy package, our policymakers at the same time strived hard to ensure a diversified capital account regime over a longer period. For one thing, this essentially meant planning for a rising share of non-debt liabilities and a low proportion of short-term debt in total foreign liabilities. And second, to achieve this perspective, a liberal yet appropriate policy frame related to FDI, portfolio investment and ECB was pursued. Thus we can say that the move towards full capital account liberalisation has been approached with cautious optimism in India.

More or less similar sentiment has been echoed in RBI Annual Report 2004-05:

India has chosen to proceed cautiously and in a gradual manner, calibrating the pace of capital account liberalisation with underlying macroeconomic developments, the state of readiness of the domestic financial system and the dynamics of international financial markets. Unlike in the case of trade integration, where benefits to all countries are demonstrable, in the case of financial integration a “threshold” in terms of preparedness and resilience of the economy is impotent for a country to get full benefits (P. 101).

Thus India has followed a gradualist approach to liberalisation of its capital account since 1993. In fact, an Expert Committee on Capital Account Liberalisation (Headed by S S Tarapore) made various recommendations for adopting capital account convertibility. These recommendations included fiscal consolidation i.e., reduction in gross fiscal deficit; mandated inflation rate;

strengthening of financial system i.e., setting of targets for CRR, NPA and deregulation of interest rates; forex risk management by banks; international accounting disclosure norms for banks and macroeconomic indicators about REER, debt service ratio and foreign exchange reserves (RBI *Report on Currency and Finance 2001-02* P. VII- 22).

Keeping in view these recommendations, fiscal deficit has of course been on the decline; inflation has been in the range of 4 to 5 percent recently; a regime of deregulated interest rates; continuous decline in CRR and NPA and even debt service ratio has shown a declining trend till 2003-04. Foreign exchange reserves cover more than a year's imports.

Despite these positive development, the Indian government has not taken final decision in regard to implementation of capital account convertibility. Nonetheless it is important to know here that there are liberal policy announcements every year related to external sector-both for trade and foreign exchange market segments. While the Ministry of Commerce and Industrial Development and Ministry of Finance have largely the domain of trade policy, foreign exchange market related announcement fall under the purview of RBI in consultation with Ministry of Finance. Related to capital account liberalisation, RBI's policy frame covers facilities for resident individuals; ii) facilities for corporates; iii) facilities for exporters and importers and iv) facilities for NRIs and PIO. While a comprehensive account of above categories of facilities is given in RBI *Annual Report 2004-05*, pp.129-131, we give below an illustration of some such facilities. Resident individuals can open Resident Foreign Currency Domestic Account in India ; commercial banks enjoy freedom to borrow or freely invest funds in overseas markets ; determine interest rate and maturity of FCNR. For corporate sector, ceiling on overseas investment has been raised to 200 of their net worth as against 100 percent hitherto. Indian companies can raise capital such as GDR/ADRs in the foreign financial markets. NGOs engaged in micro-finance activities are permitted to raise ECB up to \$ 5 million during a financial year. NRIs are permitted to raise domestic loans to finance residential accommodation in India. It is important to mention here that these facilities for various categories are updated every year, tending to achieve a liberal frame for capital account transactions.

Check Your Progress 2

- 1) Discuss the broad trends in capital account since 1990-91.

.....

.....

.....

.....

- 2) Explain some of the major determinants of BOP.

.....

.....

.....

.....

- 3) What are the issues related to current account sustainability? Do you think India's current account is sustainable under the present circumstances?
-
-
-
-
- 4) What does capital account convertibility imply? Why India has been slow on capital account convertibility?
-
-
-
-

18.8 LET US SUM UP

India began its 'tryst' with trade liberalisation in early 1990s. Policy frame encapsulated in steady current account convertibility and gradual capital account liberalisation provided considerable strength to India's BOP over the years. In capital account transactions, a liberal framework for FDI, automatic route for GDRs and ADRs for Indian companies and a congenial environment for Indian enterprises to venture abroad and providing attractiveness to NRIs and PIO deposits in Indian banks have served our BOP objectives in a viable and sustainable manner.

These policy measure have had undeniably their bearing on several BOP indicators. Relatively low current account deficit, steady flow of non-debt creating capital flows such as FDI, considerable reduction in external debt to GDP ratio and managing short term debt to tolerable levels are considered some of the positive outcomes of the policy reforms in external sector. A word about the massive foreign exchange reserves. These have created a favourable environment for boosting India's foreign investment abroad. Reflecting India's growing managerial, technological and entrepreneurial capabilities to compete in the overseas markets, its enterprises have created a 'niche' in the global market place.

Of late however, a few constraints seem to have appeared on India's BOP horizon. Relatively fast growing level of ECBs compared to FDI, non-viability of massive trade deficit and its adverse impact on current account deficit although signal early warning system, have to be taken with a pinch of salt.

18.9 KEY WORDS

Cash Reserve Ratio (CRR): CRR is the percentage of bank reserves to deposits and notes. It is fixed by the Central Bank of the Country, e.g; by Reserve Bank of India in the case of India. CRR is also known as the cash asset ratio or liquidity ratio.

External Commercial borrowing (ECB): ECBs are a very important source

of funds for corporate. It include commercial bank loans; buyer's credit, supplier's credit, credit from official export credit agencies and borrowing from Multilateral financial Institutions such as IFC, ADB etc.

Non-performing Assets: Non-performing assets are those assets or loans whose repayments or interest payments are not being made on time. A loan is a asset for a bank that usually treat these assets as non-performing if they are not serviced for some time (usually 90 days)

Non-Resident Indian (NRI): Generally speaking an India abroad is popularly known as NRI. The NRI status is legadly defined in India under Foreign Exchange Management Act, 1999 and the Income Tax Act 1961. An Indian Citizen who stays abroad for employment/business or for an uncertain duration is called NRI.

Persons of Indian Origin (PIO): FEMA defines a person of Indian Origin (PIO) as a person, being a citizen of any country (a) who at any time held an Indian Passport or (b)He/she or either of his/her parents or grand parents or great grand parents were born in or permanently resident in India as defined in the Government of India Act, 1935 and other territories that became part of India thereafter provided neither was at any time a citizen of any country as may be specified by Central Government from time to time; or (c) Who is a spouse of a citizen of India or a Person of Indian Origin as mentioned above. The scheme is broad-based, covers up to four generations and also the foreign spouse of a citizen of India or a PIO . However, the citizens of Bangladesh, Pakistan, Sri Lanka, Afghanistan, China, Iran, Nepal and Bhutan are not considered as PIO even if they satisfy the above conditions under FEMA for different purposes under different regulations. (Source: http://www.nritaxservices.com/who_nri_fema.htm)

Twin Deficits: Twin deficits refer to the fact when there is both budget deficit and trade deficit in a country. Budget deficit, as you know is the excess of public expenditure over the public revenue while trade deficit is the excess of imports over exports.

Visible and Invisible Items of Trade: The term visible iterns of trade is used as a synonymous for trade in goods while invisible items of trade refers to trade in services.

18.10 SOME USEFUL REFERENCES

RBI, Report on Currency and Finance, 2001-02; 2002-03

RBI, Annual Report 2003-04 and 2004-05

Economic Survey, 2004-05 and 2005-06.

18.11 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

- 1) Read Section 18.2
- 2) Read Section 18.3
- 3) Read Sub-section 18.3.1, 18.3.2, 18.4

Check Your Progress 2

- 1) Read Section 18.5
- 2) Read Section 18.6
- 3) Read Sub-section 18.7.1
- 4) Read Sub-section 18.7.1

UNIT 19 TRADE AND DEVELOPMENT IN INDIA

Structure

- 19.0 Objectives
- 19.1 Introduction
- 19.2 Financing of the External Payments Deficit
- 19.3 Liberalisation and Trends in FDI Flows in India
 - 19.3.1 Foreign Direct Investment and Development
 - 19.3.2 Foreign Institutional Investment (FII)
 - 19.3.3 FDI Inflows: An Appraisal
- 19.4 Institutional Mechanism for Promotion of FDI
- 19.5 Trade Liberalisation under WTO
 - 19.5.1 Tariff Reform
 - 19.5.2 India's Role in WTO Negotiations
- 19.6 Let Us Sum Up
- 19.7 Key Words
- 19.8 Some Useful References
- 19.9 Answers/Hints to Check Your Progress Exercises

19.0 OBJECTIVES

After reading this Unit, you will be able to:

- understand the problems of India's international debt during the 1980s;
- know the flow and pattern of FDI in India;
- appreciate the institutional mechanism for the promotion of FDI in India; and
- comprehend the recent changes in trade liberalisation in terms of WTO regime.

19.1 INTRODUCTION

In the earlier Units of this block, you have learnt about the trade policy from historical perspective and the recent shift in policy during nineties. You have also learnt about the balance of payments problems in India. In this Unit we will recapitulate the problem of India's International Debt during seventies and eighties and then proceed to the issues of FDI, MNCs, export promotion and trade liberalisation under WTO regime in India.

As mentioned in the previous Unit, India had a problem of external payment during eighties. This was reflected in the sharply rising debt-service ratio that steadily rose from 16-18 percent in 1980-83 to 34-38 percent during the last three years of 1987-90. Apart from this, India's current account deficit (CAD) as a proportion of GDP was also increasing. It moved up sharply from an annual average of 1.3 percent during 1980-85 to 2.9 per cent in March 1989. The growing magnitude of CAD and rising CAD/GDP ratio were posing the problems of financial constraints to meet the BOP deficit.

Falling foreign exchange reserves in relation to increasing import requirements was of the magnitude of US \$ 15 billion over the first eight months of 1988-89. Evidently the country was depleting its foreign exchange reserves to meet the

external liabilities. From what has been documented on the trends in India's balance of payments in the previous Unit, it is evident that by the early nineties the nation's current liabilities continued to be on the increase, with uncertainty and unpredictability in terms of maintaining the on-going pattern of financing through net private transfers.

A rise in the CAD/GDP ratio on the one hand, reflected the growth in current external liabilities. Reliance on net private transfers as the major source of non-merchandise current earnings, on the other raised the question of the viability of the current mode of external financing. This was particularly serious in the face of the steady increases in interest liabilities. It was apparent that the nation would be soon compelled to accept further reductions in the flow of real transfers as a proportion of GDP. The need had thus arisen to find additional sources of finance in the capital market at terms which would not preclude the possibilities of securing a rise in real transfers.

19.2 FINANCING OF THE EXTERNAL PAYMENTS DEFICIT

The trend in India's widening CAD during the second half of the eighties, both in absolute terms and also as a proportion of the GDP, increased the need for securing an adequate flow of external finances. This was crucial to prevent the country from being forced to accept further cuts in the flow of imports from abroad. The situation needs to be viewed in terms of the prevailing state of the country's external indebtedness and the potential of her future borrowings by the end of the eighties. The table below presents the scenario obtained in this regard.

Table 19.1: India's External Debt

(Rs. Crores)				
Year	Outstanding and Disbursed	Gross Disbursement	Interest and Amortization	Net Inflow
1	2	3	4	5
A. External Assistance				
1984-85	27462	2354	1176	1178
1985-86	27397	2938	1367	1571
1986-87	33201	3596	2029	1567
1987-88	33426	5032	2623	2409
1988-89	48002	5291	2946	2345
B. External commercial borrowings (ECB) including supplier credit				
1984-85	6413	1084*	682	402
1985-86	7647	1234	1175	59
1986-87	10321	2674	1565	1099
1987-88	12635	2314	1813	501
1988-89	17482	4847	2135	2712
C. IMF				
1984-85	4550	-	-	63
1985-86	4665	115	368	-253
1986-87	4826	161	833	-672
1987-88	4348	-478	1687	-1209
1988-89	3347	1001	1995	-954
D. Non-resident Indian (NRI) deposits				
1984-85	3819	-	-	-
1985-86	5650	1831	-	-
1986-87	7847	2197	-	-
1987-88	10054	2207	-	-
1988-89	14154	4100	-	-

*Approved.

Source: Sep 2000 p.66

As Table 19.1 shows, external finance could in principle be availed of from multilateral official sources (primarily IMF), external commercial borrowings including supplier credit, NRI deposits on a short-term basis and, finally, by preventing herself from further depletions, from the country's foreign exchange reserves. Of these, the net flows of finance from the IMF had already become negative by 1985-86. The other sources of external finance (including both corporate borrowings and NRIs at commercial terms), began to acquire significance only by the early nineties. Notwithstanding the steady rise in gross authorisations of ECBs since the beginning of the eighties, net disbursements was slow to follow during the period 1985-86 to 1988-89. In the meantime, debt servicing on ECBs moved up steadily, and the authorised ECB credit maintained an upward trend over the period. In sum therefore, the situation by the end of 1980s was one in which the debt charges (interest and amortisations) increased at a faster rate than gross disbursements of external loans.

Check Your Progress 1

- 1) What was the problem of India's international debt?

.....

.....

.....

.....

.....

- 2) Differentiate between external assistance and external commercial borrowing?

.....

.....

.....

.....

.....

19.3 LIBERALISATION AND TRENDS IN FDI FLOWS IN INDIA

19.3.1 Foreign Direct Investment and Development

In neo-classical economic theory, FDI involves the movement of capital from capital abundant to capital scarce host countries. Mundell (1957) propounded that FDI promotes greater production and welfare in the same manner as trade in goods under trade liberalisation. Akamatsu (1961, 1962) provided 'flying geese theory'. According to this theory, FDI through MNCs disperses production technology and know-how from a high wage source country to one or more lower wage host countries. Kindleberger (1969) accorded significance to the compensating advantage in the host country, which allows it to compete on equal terms with indigenous firms.

One of the most prominent explanations of international production, which has gained academic popularity, is Dunning's 'Eclectic Paradigm'. Though this paradigm seeks to explain the FDI it does not distinguish between various modes of entries to foreign countries. It primarily explains the Greenfield ventures. It suggests that foreign direct investment (FDI) takes place when following three factors are existing simultaneously, namely,

- i) ownership specific advantages: The firm has comparative advantage in the knowledge it 'owns'. We may refer it technology, patents, etc,
- ii) locational advantages of host countries: such as huge market in the host country, or lower cost of local resources or elimination of tariffs that induce the firms to locate in host country etc., and
- iii) internalisation advantages: It means the endeavour of the firm to produce goods itself, rather than licensing its technology.

The first one reflects firm-specific determinants, whereas the locational advantage is specific to particular country, which explains why FDI flows to some countries and not others. Thus OLI (taken from the first letters of the above mentioned advantages) paradigm addresses the following questions such as: a) *which* firms do undertake FDI, b) *where* do the firms go for their direct investment and c) *why* do they internalise their advantages through direct investment instead of selling it off. Thus a combination of factors determines the forms of production and the way market is being catered and serviced.

Different factors have been identified by the growth theories that play a role in promoting economic growth such as savings and investment (classical models), technical progress (neo-classical models), and R&D, human capital, accumulation and externalities (new growth theory). FDI has been integrated into these growth theories in such a way that it adds to the existing capital stock and has growth effects similar to that of domestic investment. It improves exports and helps the access of domestic enterprises to international markets. Thus traditionally a number of factors have been considered that influence the flow of FDI to developing countries. These factors include natural-resource endowments, location factor, human capital, infrastructure and institutions. Of late according to Addison and Heshmati (2003) information and technology influences the flow of FDI to developing countries. Similarly, there are other research studies that have recognised factors like market size, socio-political instability, business operating conditions, wage costs, exchange rate, trade barriers, export-orientation, openness of developing host countries, democratisation and risk. Determined by these factors, the distribution of FDI flow has been skewed worldwide. According to UNCTAD (2001) 15 countries account for 80 percent of FDI to developing countries and 49 least developed countries (LDCs) have attracted only 0.3 percent of world FDI inflows in 2000. According to World Bank (2001), between low-income and middle-income developing countries, it was the latter group attracting more FDI inflows because the productivity of investments. Thus the top ten recipients of private capital flows in developing countries were Argentina, Brazil, Chile, China, India, Indonesia, Korea, Malaysia, Mexico and Thailand.

The economic rationale for offering special incentives to attract FDI frequently

draws from the belief that foreign investment produces externalities in the form of technology transfers and spillovers. Romer (1993) for example, argues that there are important 'idea gaps' between rich and poor countries, reminding that foreign investment can facilitate the transfer of technological and business know-how to poorer countries, which may have substantial spillover effects for the entire economy. Thus, foreign investment may boost the productivity of all firms – not just those receiving foreign capital. It has been pointed out that the entry of a multinational corporation (MNC) represents something more than a simple import of capital into a host country as it brings with it so many other influences such as in terms of culture change- in the working patterns and within the society. Thus while a number of studies have warned against negative impacts of FDI flows, there is majority agreement on the positive impacts of FDI on the welfare of receiving countries.

The evidence in fact, suggests that flow of private capital is generally bound to have a significant impact on the domestic economy – be it in terms of change in domestic investment or enhancing productivities, impact on the capital market, technology transfer, market access, investment opportunities and export promotion among others. Thus the research studies have assumed a mutually reinforcing relationship between private capital flows and domestic growth. Velda (2001) established that industrial and macro economic policies of host countries influence the flow of FDI to them. Dunning (2002) identified two factors responsible for the selection of host country by any MNC. These are: i) MNC's own motivation to relocate its activities in the new global economic environment because of the motives like market seeking, resource seeking, efficiency seeking and asset seeking in the host countries. ii) Economic and business environment of the host country.

19.3.2 Foreign Institutional Investment (FII)

Foreign investment flows in the balance of payments (BOP) comprise FDI flows and portfolio flows. The latter consists of resources mobilised by Indian companies through American Depositary Receipts (ADRs) and Global Depositary Receipts (GDRs). The data in this respect is presented for the period 1991-2005 in Table 19.2. From the trends discernible therein, it follows that the net inflow of investment from both the types of investments was fluctuating till the year 2003. A clear picture, however, appears to be evident after 2004.

Compared to FDI, FII or portfolio investment flows into the Indian economy were not one of the leading varieties of capital flows until 2003-04. In the aftermath of the 1997 East Asian crisis, such flows had actually become net outflows. While there was a modest recovery in 1999-2000, languishing FII flows steadily declined in 2002-03. However, the years 2003-04 and 2004-05, have been remarkably robust years for such flows. Beginning from 1993-94, till 2002-03, the highest share of FII (net) flows in total foreign investment inflows was recorded at 43.5 per cent in 1995-96. During 2003-04 and 2004-05, their share shot up to 79.4 percent and 68.2 percent, respectively, indicating the significant contribution being made by FII investment to the capital account in recent years. During the year 2005-06, FII investment has maintained the healthy trends of the previous two years.

Table 19.2: Foreign Investment Inflows

(Rs. crore)

Year	A. Direct investment (or FDI)	B. Portfolio investment (or FII)	Total (A+B)
1	2	3	4
1990-91	174	11	185
1991-92	316	10	326
1992-93	965	748	1713
1993-94	1838	11188	13026
1994-95	4126	12007	16133
1995-96*	7172	9192	16364
1996-97*	10015	11758	21773
1997-98*	13220	6696	19916
1998-99*	10358	-257	10101
1999-00*	9338	13112	22450
2000-01*	18406	12609	31015
2001-02*	29235	9639	38874
2002-03*	24367	4738	29105
2003-04*	21473	52279	73752
2004-05* P	24870	40029	64899

P: Provisional.

* Includes acquisition of shares of Indian companies by non-residents under Section 6 of FEMA, 1999. Data on such acquisitions are included as part of FDI since January 1996.

Source: RBI Handbook of Statistics on Indian Economy, 2005

The acceleration in volume of FII inflows in recent years has drawn attention to whether India's capital account is becoming increasingly dominated by 'hot money' – a phrase commonly, but incorrectly, used for describing FII flows – given the tendency of such flows to suddenly reverse the direction in response to adverse market sentiments and precipitating large capital outflows. While theoretically 'herd' behaviour by FIIs and consequent withdrawal cannot be ruled out, such possibilities are limited if the fundamentals are strong, the market is well regulated and the participants are mainly pension funds, life insurance companies and mutual funds, which are more involved with longer term investments. Hence notwithstanding a quantum jump in volume of FII flows in recent years, low levels of short-term debt as a proportion of total external debt and adequate reserve coverage mitigate the risk of potential reversals.

19.3.3 FDI Inflows: An Appraisal

A comparison of the magnitude of FDI inflows received by India would appear too small, especially when compared to the inflows received by other countries in the region such as China (around \$50 billion in recent years). But taking a ratio of FDI to GDP, however, narrows down this difference. The industrial growth seems to signal the prospects of the economy to the foreign investors. However, policy liberalisation may at best be viewed as a necessary but not a sufficient condition for FDI inflows. This is because studies have found that only a part of the increase in FDI inflows could be attributed to liberalisation. A significant part of the rise was found as due to a sharp expansion in the global scale of FDI outflows during the 1990s. Moreover, the decline in inflows of FDI since 1997 suggest that policy liberalisation is not an adequate explanation of FDI inflows.

a) Liberalisation and Changing Sectoral Composition of FDI

Successive waves of innovation and new technology have always influenced

the scale, character and magnitude of FDI flows to developing countries. The latest is the ICT wave that has influenced the global shift in service industries the most. Therefore, these flows are now accompanied by a change in the composition of such flows more and more in the new economy sectors including telecommunication, electronics, and information technology. The evidence is that for the developing world, a modern telecommunications infrastructure is not only essential for domestic economic growth, but also a prerequisite for participation in increasingly competitive world markets and for attracting new investments. With this realisation developing countries have begun to acknowledge that inadequate telecommunications infrastructure will be a disincentive to new investment and therefore place existing industry at a competitive disadvantage.

The sectoral composition of FDI in India has undergone significant change in the 1990s. Some characteristics of FDI stock in India can be noted. i) The share of mining and petroleum along with plantation sector in FDI stock has fallen (from 9 per cent in 1980 to only 2 per cent in 1997). ii) The bulk of FDI inflows in the pre-liberalisation era were directed to manufacturing sector, (its share was 87 per cent in 1980 that declined to 85 per cent in 1990). However, with the liberalisation of FDI policy regime in the 1990s, FDI inflows have been received more by services and infrastructural sectors. This has brought the share of manufacturing down to 48 per cent by 1997. During the 1990s, services clearly emerged as a major sector receiving FDI. Power generation (among other infrastructure sectors) has also attracted substantial FDI during the 1990s.

Among the manufacturing sub-sectors, FDI in 1997 was more evenly distributed among the following sectors food and beverages, transport equipment, metals and metal products, electricals and electronics, chemicals and allied products, and miscellaneous manufacturing. This was in contrast to a very heavy concentration in technology intensive sectors, like machinery, chemicals, electricals, and transport equipment up to 1990. The infrastructural sectors, which have commanded nearly half of total approved investments in the 1990s had not been open to FDI inflows before and hence could be attributed to the policy liberalisation.

It may be useful to look at the distribution of inward FDI within the services sector given its increasing importance in the FDI inflows during the 1990s. A look at the sub-sector break up of cumulative approvals of FDI during the 1991-2000 periods suggests that about 61 per cent FDI has gone to the telecommunications sector. The financial and banking sector stood as the second most important sector claiming about 14 per cent of total amount approved. Other important sectors are hotel and tourism, and air and sea transport.

b) Liberalisation and Changing Sources of FDI in India

European countries had been major sources of FDI inflows to India until 1990. However, their relative importance declined in the post-liberalisation period. The share of major European countries (which include the UK, Germany, France, Switzerland, Sweden, Italy and Netherlands) came down to 66 per cent in 1990 to just 31 per cent in 1997. As Table 19.3 shows that in place of UK, Mauritius and US has emerged as the most important source of FDI over this period. As per RBI bulletin 2005, Mauritius and US continued to remain the dominant

sources of FDI to India. New players like Malaysia have also emerged to the scene as big investing country.

Table 19.3: Share of Top Five Investing Countries in FDI inflows

	<i>(percent)</i>		
Country	1992	1997	2002
Mauritius	-	17.93	38.23
US	18.57	13.75	15.42
UK	40.23	11.99	6.01
Germany	12.40	5.69	n.a.
Japan	5.55	5.36	14.84
Malaysia	-	-	14.82
Others	8.44	33.62	10.68
Total	100	100	100

Source: RBI Bulletin, October 2000 and SIA Newsletter 2002

c) Liberalisation and Mode of Entry: Greenfield vs. M & As

Various new forms of FDI flows have also emerged. Besides mergers and joint ventures, transactional relationships are emerging such as licensing, franchising, management controls, turnkey ventures and international subcontracting, strategic alliances etc. This is another important feature of FDI inflows into India during 1990s is the emergence of mergers and acquisitions (M & As) as an important channel of FDI inflow. During the period 1997-1999, for instance, nearly 39 per cent of FDI inflows into India have taken the form of M & As by foreign companies of existing Indian enterprises. In the pre-reform period, FDI entry was invariably in the nature of green field investments. This trend may have implications in terms of additions to the stock of productive capital, technology transfers, generation of competitive atmosphere and so on.

Check Your Progress 2

1) What are the factors that determine the inflow of FDI?

.....

.....

.....

.....

2) What are the trends of FDI and FII since 1990-91?

.....

.....

.....

.....

3) How has the sectoral composition of FDI changed over the years?

.....

.....

.....

19.4 INSTITUTIONAL MECHANISMS FOR PROMOTION OF FDI

There is increasing recognition that understanding the forces of economic globalisation requires taking a look at foreign direct investment (FDI) by multinational corporations (MNCs). In India, while inclination towards the policy of export promotion and attracting foreign direct investment was referred in earlier policy documents as a point here and there, it was industrial policy Resolution, of 1991 that came out openly for the first time with the provisions for FDI and foreign technology agreements as under:

While freeing Indian industry from official controls, opportunities for promoting foreign investments in India should also be fully exploited... the relationship between domestic and foreign industry needs to be much more dynamic than it has been in the past in terms of both technology and investment. Foreign investment would bring attendant advantages of technology transfer, marketing expertise, introduction of modern managerial techniques and new possibilities for promotion of exports. This is particularly necessary in the changing global scenario of industrial and economic cooperation marked by mobility of capital. The government will therefore welcome foreign investment which is in the interest of the country's industrial development.

In order to invite foreign investment in high priority industries requiring large investments and advanced technology, the policy decided to provide approval for direct foreign investment upto 51 percent foreign equity in such industries. The intention was to make Indian policy on foreign investment transparent and attractive for companies abroad to invest in India. The policy also envisages the promotion of exports of Indian products and therefore recognised the need for a systematic exploration of world markets possible only through intensive and highly professional marketing activities. In the absence of the expertise of this nature in India at that time, the Government decided to encourage foreign trading companies to assist in our export activities. Attraction of substantial investment, access to high technology and to world markets involved interaction with international manufacturing and marketing firms. It was decided that the Government will appoint a special board to negotiate with such firms for providing avenues for large investments in the development of such industries and technology which are of the national interest.

In order to promote an industrial environment where the acquisition of technological capability received priority, it was decided to ease out the approval process. With a view to injecting the desired level of technological dynamism in Indian industry, the government also decided to provide automatic approval for technology agreement related to high priority industries within specified parameters. Indian companies were also provided with the free hand to negotiate the terms of technology transfer with their foreign counterparts. In order to help the process of efficient absorption of foreign technology, the hiring of foreign technicians and foreign testing of indigenously developed technologies, were exempted from taking prior clearance as needed before.

A steering committee on FDI was set up by Planning Commission in 2001 to suggested measures to promote foreign investment. The committee submitted its report in 2003. The major promotional measures suggested included:

enactment of a foreign investment promotion law, urging states to enact special investment laws to promote infrastructure for attracting foreign investments, empower foreign investment promotion board (FIPB) for granting initial level registrations and approvals, empower Foreign Investment Implementation Authority (FIIA) for expediting administrative and policy approvals etc. A manual on policy and procedures on FDI in India was issued by the government of India in 2003. The manual referred to the industrial licensing policy laying down the rules and procedures for FDI. The following ways were referred such as: i) automatic route where 100 percent approval was given, and ii) government approvals where permission was required for some of the activities. Both the policies were available for FDI, foreign technology agreement, EPZs/SEZs and hardware and software technology park Schemes. The procedures regarding getting approvals were laid down separately for each of the category. The institutional facilitation was provided by Secretariat for Industrial Assistance (SIA), FIPB, FIIA, Foreign Investment Promotion Council (FIPC), Investment Promotion & Infrastructure Development (IP&ID) Cell and so on were established to facilitate the investors with guidance and help.

19.5 TRADE LIBERALISATION UNDER WTO

In the Uruguay Round negotiations, India agreed to reduce tariff on a large number of commodities and remove quantitative restrictions (QRs) on all, except for about 600 commodities. For industrial products, India's commitment was to bring down the average tariff rate from 71 per cent in the pre-Uruguay Round period to 32 per cent in the post-Uruguay Round era.

While the 1991 reforms removed QRs on most manufactured intermediate and capital goods, there was little change in the import policy for textiles and clothing. The imports of these products remained practically banned. The situation began to change substantially in December 1994 when in separate treaties with the EU and the USA, India agreed to a comprehensive liberalisation of import policies for textiles. This liberalisation in imports of textiles was agreed to in part as quid pro quo for the ATC (Agreement on Textiles and Clothing) to phase out the MFA quotas, and in part in exchange for increased MFA quotas in the US and EU markets. The reform process started in 1995 with the removal of QRs on imports of wool tops, synthetic fibers, textile yarn and some selected industrial fabrics. It was also agreed that these products would be free from import licensing altogether at specified future dates (1998, 2000 or 2002), and tariff rates would be reduced to levels between 20 and 40 percent by 2000.

Turning now to other international agreements, India had used the balance of payments provision given in GATT (Article VIII (B)) to justify her routine use of QRs. Soon after the Uruguay Round agreements became effective India's unconstrained use of the balance of payments provision was challenged by the US, EU and other developed countries. It became difficult for India to justify QRs on grounds of balance of payments since there was a strong current account, substantial capital inflow and large foreign exchange reserves. In 1999-00, 2134 items were subject to QRs, of which 1589 items had QRs on imports, being maintained under the balance of payments provision. India reached mutual agreement with Australia, Canada, EU, New Zealand

Switzerland and Japan for elimination of QRs on these products in a phased manner by March 31, 2003. The US, however, did not agree to this plan, and persisted in the Dispute Settlement Body. The US won the case and India had to eliminate QRs on all commodities (except the 600 odd items mentioned above). QRs on imports were removed for 715 items in *Export-Import Policy of 2000/01*, and for another 714 items on April 1, 2001.

19.5.1 Tariff Reform

India's customs tariff rates have been declining since 1991. The "peak" rate came down from 150 percent in 1991-92 to 40 percent in 1997-98. The downward momentum was reversed the next year with the imposition of a surcharge. This momentum resumed with the reduction of the "peak" rate to 35 percent in 2001-02 and 30 percent in 2002-03. "Peak" rate (applicable to all manufactured and mineral products except alcoholic beverages and automobiles) was reduced to 20 percent at the end of 2003-04. It is therefore quite evident that India has drastically reduced the level of tariff, particularly industrial tariff, in the period since 1991. Many research studies have argued that this reduction should not, however, be attributed to India's commitment under WTO because the tariff rates have in most cases been brought down to a level well below the rates committed. It seems reasonable to argue that the tariff reform undertaken by India in the last 14 years was mostly done at India's own initiative (induced by the benefits expected from such reforms) and had little to do with India's commitment under WTO.

Similarly many researchers have studied the impact of India's trade reforms, particularly tariff reforms, on domestic industry. It appears that tariff reforms did not lead to a general surge in imports of industrial goods adversely affecting domestic industry. On the other hand, there is some evidence to indicate that tariff reform contributed to higher industrial productivity and better export performance. But, these effects however, cannot be ascribed to India's tariff commitments under WTO, since the tariff reform took place largely independent of the WTO.

19.5.2 India's Role in WTO Negotiations

As is obvious from the above explanation that India has favoured multilateral trade reforms ever since the time of GATT (1947) to WTO (1995). Currently WTO discussions include a variety of issues as mentioned in the previous Units 5 and 6 of Block 2. To recapitulate, India's overall stand in WTO rounds of negotiation range from, IPRs, trade in services, agriculture, non-agricultural market access and dispute settlement mechanisms.

WTO was originated at Uruguay round in Marrakesh. Since then talks on the Doha Round are going on. The first meeting held at Seattle led to the emergence of many controversies between developed and developing countries. These controversies included agricultural subsidies, environment, and child labour. A significant development was emergence of G-20 nations including India, Brazil and China. These countries were considered critical in charting a positive and speedy path of convergence in the ongoing negotiations. To begin with, these countries, however, had played a negligible role in earlier negotiating rounds. The attention was exclusively on the

interplay between the European and the American trade representatives, who were treated as the stars of the trade talks and other countries were sidelined to anonymity. At Cancun, however, this dynamics finally changed. Brazil took a dramatic stand, planting the flag of the developing world on the MTN map and forcing the world to pay attention to its interests. As against the past years where the United States, the EU, Japan, and Canada had set the terms of the negotiations, the scenario changed and after Cancun (2003), however, the agenda was set by a new Group of five, which included the United States, the EU, Brazil, India, and Australia (as a representative of the Cairns Group of 17 agriculture-exporting countries).

Cancun thus represented a triumph for developing countries, which suddenly gained recognition and a political stake in the negotiations. Indeed, the G-20 even managed to demand successfully and the EU and the United States were asked to come back with improved offers on agricultural subsidies and trade barriers. Before the WTO Ministerial meeting in Hong Kong (2005), there were reasons for pessimism about what shape negotiations will take. The most difficult issues included lowering agricultural protections. New groups and lobbies had already been formed on this issue among the developed nations. Washington and Brussels have lobbied for related offers and counter offers at each other without much progress. The EU was divided between France and its allies, which opposed making any serious concessions, and the United Kingdom and the Nordic countries, which favoured making concessions.

The success of Hong Kong was considered because of the scaling down of ambitions all around and a renewed commitment by all to refocus on the development aspect of the Doha Development Agenda (DDA). It is stated that developing country members, including India, have the most to gain from multilateral trade liberalisation under the WTO. A successful conclusion of the DDA will help countries secure more rapid economic growth and reduce inequality.

In the WTO ministerial conference held at Hong Kong in December 2005, the issues at stake for India was trade in services, agriculture and non-agriculture market access. The pro-active role was played by the developing countries under the aegis of G-20.

The main achievement of the Hong Kong Ministerial, on the contrary, has been an agreement on the elimination of export subsidies in agriculture, some reduction in domestic support for agriculture and commitments on trade facilitation to indicate significant progress. However, no progress was possible on agricultural and non-agricultural tariffs, or on services. And as this block of lessons was being finalised in July 2006, the latest developments at the WTO indicate that the negotiations have broken down, and the future of the Doha Round is in doubt.

India's active role in Hong Kong has been recognised by all, including the WTO Secretariat. As compared to the Uruguay Round, India today is considered in a relatively stronger position, given its established strengths in services and emerging strength from unilateral liberalisation in manufacturing in the recent past. India's trade negotiators therefore have a leading role to play in carving out an outcome from the Negotiations, if and when they resume, that adequately addresses the concerns of various stakeholders.

- 1) Discuss the institutional mechanism provided for the promotion of exports and FDI.

.....

.....

.....

.....

- 2) Critically discuss the tariff reforms under WTO in India.

.....

.....

.....

.....

- 3) Analyse the role of India in WTO negotiations.

.....

.....

.....

.....

19.6 LET US SUM UP

The problem of India's trade deficit that came into prominence in eighties is still persisting. While in late eighties there were many reasons (you have learnt about these reasons in the previous Unit) triggered by the implementation of fourth pay commission recommendations that had put pressure and worsened the fiscal situation that led to the balance of payments crisis, presently it is the mounting oil import bill, which is the cause of the concern. The Economic Advisory Council of the government pegs the current account deficit at 2.9 percent of GDP, in 2005-06. India, however, depends largely on the Foreign Institutional Investment Flows that are likely to increase. The current scenario of FII inflows, however, can not be taken for granted as they may pull out large sums of money as easily as they invest. Therefore, measures to attract FDI need to be taken more seriously. With the move of the government towards setting up a committee for inviting suggestions on the full convertibility of rupee or the capital account convertibility, another step has been taken towards this direction to attract FDI. This move has attracted different opinions and the results of which are yet to be seen.

Against this backdrop, in the present Unit you have learnt about the emergence and then the means of tackling external payments deficit. You have also learnt about the liberalisation and the trends in FDI during recent years. The Unit also explains to you the institutional mechanism and policies available in the country to attract FDI and promote exports. Last but not the least the unit comprehends the recent trends in trade liberalisation under WTO and explains the significance of the role played by India in WTO negotiations.

19.7 KEY WORDS

Current Account Deficit: In the balance of payments, or in any category of international transactions within it, the deficit is the sum of debits minus the sum of credits, or the negative of the surplus.

Greenfield Investments: FDI that involves construction of a new plant, rather than the purchase of an existing plant or firm. It contrasts with brown field investment, which is FDI that involves the purchase of an existing plant or firm, rather than construction of a new plant.

Hot money: Holdings of very liquid assets, which may be sold or encashed on short notice and then removed from a country, often in response to expectations of devaluation or other financial crisis.

Herd Behaviour: The “collective” behaviour emerges from uncoordinated individual choices. Interestingly, though the behaviour of the group is evidently irrational, the behaviour of the individuals that cause it is rational at least in the short term, though it does show some abandonment of risk aversion, as the crash usually occurs without much warning. These phenomena are now much better understood as a result of investigations in experimental economics and behavioural finance, particularly by Nobel laureates Vernon Smith and Daniel Kahneman.

19.8 SOME USEFUL REFERENCES

Chawla, R.L. 2003. India and WTO. *India Quarterly Journal* Vol. LIX, Nos. 3&4. July-December

Goldar.B. 2005. *Impact on India of Tariff and Quantitative Restrictions under WTO*. ICRIER Working Paper no. 172. New Delhi

Kehal.H.S. (ed.) 2005. *Foreign Investment in Rapidly Growing Countries – The Chinese and Indian Experience*. Palgrave Macmillan. U.K.

Kumar.N. 2005. Liberalisation, Foreign Direct Investment Flows and Development – Indian Experience in the 1990s. *Economic and Political Weekly*. April 2.

Sen.S. 2000. *Trade and Dependence – Essays on the Indian Economy*. Sage Publications, New Delhi.

19.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

- 1) Read Section 19.1 and 19.2
- 2) Read Section 19.2

Check Your Progress 2

- 1) Read Sub-section 19.3.1

2) Read Sub-section 19.3.2

3) Read Sub-section 19.3.3

Check Your Progress 3

1) Read Section 19.5

2) Read Sub-section 19.6.1

3) Read Sub-section 19.6.2

EXERCISES FOR MEC-007 (BLOCK 1 to 6)

- 1) Briefly discuss the Hecksher-Ohlin Theorem of International Trade.
- 2) Explain what are the various extensions of Hecksher-Ohlin Theorem?
- 3) What are the various alternative explanations to the theory of International Trade? How comparative advantage theory is different from dynamic comparative advantage?
- 4) Critically examine the traditional trade theories of comparative advantage.
- 5) What are the arguments given in favour of free trade policy as a tool of Economic Development?
- 6) What are the various theories and justifications for protectionism? Discuss briefly.
- 7) What are the Various Instruments of trade protection? Differentiate between tariff and non-tariff barriers.
- 8) Explain the main features of multilateral framework of international trade.
- 9) What is unfair trade? Discuss various forms of unfair trade.
- 10) What are the basic problems of developing countries in this era multilateralism?
- 11) Discuss how under WTO, differential treatment in reverse is different from special and differential treatment.
- 12) How will you explain the Balance of Payments of a country? Describe current account and capital account system of balance of payments.
- 13) What are the salient features and experiences of Gold Standard regime during 1880-1914?
- 14) What do you understand by principles of adjustment? Discuss income adjustments and price adjustments of exchange rates.
- 15) Critically examine the funding policies of IMF and The World Bank.
- 16) Critically discuss the role of ADB as an International Financial Institution.
- 17) Describe analytically the external debt crisis of the developing countries during 1970s and 1980s.
- 18) Critically discuss the role of public external debt as a means of financing budget deficits.
- 19) What was the rationale for adopting an Import Substitution Industrialisation Strategy (ISI)? What are the appropriate tools for implementing an ISI strategy?
- 20) What are the different aspects in which research on Trade policy and Growth has taken place? Discuss.

- 21) What are the various concepts of terms of trade (TT)? Discuss the behaviour of TT of primary commodities.
- 22) Why does the importance of services grow in the structure of production overtime. Give theoretical explanation in support of your arguments. What are the consequences of inclusion of services in multilateral trade negotiations?
- 23) Discuss the process of negotiations on services under Uruguay Round. Why it is important for India?
- 24) What was the rationale for liberal trade? What are the basic principles of the GATT? Discuss the role of developing countries under GATT.
- 25) Discuss the theories of Regional Trading Blocs. Are regional trading blocs considered as promoters of global trade?
- 26) What are the theoretical arguments for globalisation and macro economic management? Discuss.
- 27) Briefly discuss the evolution of International monetary system and its present status.
- 28) What were the reason of East-Asian Crisis? What are the lessons learnt for developing countries?
- 29) Give a brief account of Indian Trade Policy since 1950.
- 30) What were the components of India's Trade Policy reforms since 1990.
- 31) Briefly discuss India's Trade performance over the years.
- 32) Critically examine India's strategic consideration for trade in recent years.
- 33) What were the reasons for Balance of Payments Crisis in 1990s? What are the trends in current account and capital account.
- 34) Critically evaluate the issues related to Balance of Payments in India. What are the determinants of BOP?
- 35) What is the relationship between FDI and development? Give a brief account of FDI inflows in India.
- 36) Discuss the process of Trade liberalisation under WTO in India.

EDITORIAL OVERVIEW OF THE COURSE

It is common to say that we live in an era of globalisation. This course has tried to explain how economists analyse this phenomenon. Our focus has been on the causes and effects of freer international flows of goods, services and capital, and the major institutions and policies governing these flows, with special reference to India. The authors have attempted to provide only the necessary minimum theoretical and historical background to understand contemporary developments.

The learners should be aware of the two limitations of this approach. First, the course does not attempt to go into abstract models for their own sake, which is difficult to do through the distance mode. However, an MA-level specialised/ optional course in international economics would normally have a much greater focus on theoretical models. IGNOU does not at present offer such a course, so those learners who wish to develop a higher level of competence in this area should go through all the chapters of the books by Salvatore or Soderstrom and Reed, which were mentioned as Useful References in Units 1-4 and 8. They can then attempt to read some of the technical papers published in professional journals, which are also given in the references, and the following standard post-graduate textbooks:

- 1) *Lectures on International Trade* by Jagdish Bhagwati, Arvind Panagariya, and T.N. Srinivasan (Oxford University Press, India).
- 2) *Open Economy Macroeconomics* by Rudiger Dornbusch and Stanley Fischer.

The second limitation of an issues-oriented course is that some facts described in the course materials might soon become outdated, as these developments are rapidly changing both in India and in the international economy. Already, between the writing of the lessons in early 2006 and the printing of the course material in mid-2006, the WTO Doha Round negotiations as well as discussions towards the India-ASEAN FTA have been suspended. They may or may not resume in the near future, and may take a different direction if they do. Also, the recent trend of rising oil prices, inflationary trends in the Indian economy (which will adversely affect the competitiveness of exports), and very large Foreign Institutional Investments (which may reverse at short notice) may result in the descriptive material on India's BOP becoming outdated quite soon. Learners are encouraged, therefore, to follow ongoing developments through the media and articles in journals such as the *Economic and Political Weekly*. Even if the factual material presented in this course becomes obsolete, it is hoped that the concepts and theories that readers have absorbed will be of long-term benefit to them in understanding the unfolding events.

Some clarifications are necessary on the way in which the course materials have been edited. It is natural that in a course where the materials have been contributed by so many different authors working independently, there may be different levels of difficulty of the different Units, and some authors may use concepts assuming that they have been explained in earlier Units. Considerable editorial effort has been devoted to minimising these problems. On the other hand, some authors may unintentionally duplicate what has been covered by other authors. Some of this repetition has been eliminated, but some has been

retained, as it helps the learners to absorb the material. In several cases, cross-references have been added so that readers may refresh their memories of the concept under discussion from the relevant earlier Units.

The other issue, which arises when different authors write different Units, is that they may give contradictory opinions on some issues. These contradictions have also been retained, as it gives the readers an appreciation that there is no unanimity of opinion amongst economists on many vital issues, especially concerning the effects of globalisation and liberalisation. Learners are encouraged to assess the different arguments and come to their own conclusions.

Finally, the Course Editor would like to convey his thanks to the authors of many of the Units for agreeing to major changes at short notice. He would also like to thank Dr Madhu Bala of IGNOU for taking this whole course upto the level of printing, acting as the intermediary between him and the authors (who remained anonymous throughout the editing process), and for formatting the Units as per distance education mode and supplying much of the supplementary material such as definitions of key concepts, questions and summaries at the end of the Units.
