PART I

A REVIEW OF FOREIGN TRADE AND OTHER RELATED DEVELOPMENTS

The past 50 years have witnessed several changes in the external sector. With liberalization and the increase in openness of the Indian economy, the external sector now has a key role to play in India's development process.

In 1950, India's share in world exports was 1.9 percent. This compared favourably with 0.9 percent in China and 1.4 percent in Japan (Srinivasan and Tendulkar, 1999). By 1965, however, the share had dropped to 1 percent (Bhagwati and Desai, 1970) and it continued to fall progressively to one-fifth its initial level to 0.45 percent in 1980 and recovered marginally in 1997 to 0.62 percent (Table 1).This was in sharp contrast to Japan's and China's experience. The Chinese share in world exports, after initially falling to a low of 0.7 percent in 1977 increased to 3.2 percent in 1997 while Japan's share increased from 1.4 percent in 1950 to a peak of 10.3 percent in 1986 (Srinivasan and Tendulkar, 1999). This rapid growth was achieved by Japan's emphasis on export orientation to industrialisation and China's change in policy towards progressive integration with the world economy since 1978. India, on the other hand, persisted with the inward orientation in its policies till 1991 with a gradual change towards globalization after that. While there was some change in emphasis on exports reflected in the ratio of exports to GDP (Table 2) that rose from an annual average of 3.41 percent in the 1960s to 3.68 percent in the first half of the 1970s and to 5.26 percent in the latter part of the 1970s, import substitution primarily dominated the development strategy until the end of the 70s. More recently, the exports to GDP ratio has grown to almost 8.5 percent.

We begin with a broad overview of India's external sector since the 1950s[1]. Until the crisis of 1991, India's trade policy was based on three main objectives (Marjit and Chaudhuri, 1997): preservation of employment in the import competing sectors; raising revenue through trade restrictions; and promoting self-reliant industrialisation. Bhagwati and Srinivasan's (1993) study clearly shows that exports were not given adequate attention until the early 90s, when the foreign exchange reserves were at an all-time low. Exports were, in fact, discouraged due to the pro-import competing policies.

During the first half of the 1950s, the assumption of export pessimism led to high export taxes and investment in the export sector was neglected. Further, the import regime was quite liberal. In fact, capital controls were more restrictive than import controls. (Joshi and Little, 1994).

It was with the Second-Five Year Plan covering the period 1956-61 that a strategy for development was adopted. This strategy emphasised the establishment of basic and heavy industries for rapidly industrialising the economy. However, the implementation of the strategy led to a massive increase in imports in the first two years of the Second Plan. Imports increased by about 23 percent in 1957-58 (Table 5). This was on account of the rational expectation of the private sector of an increase in import demand, which was implied by the development strategy and the anticipated shortage of foreign exchange (Srinivasan and Tendulkar, 1999). This phenomenon was accompanied by a severe balance of payments crisis in 1957. This led to introduction of import controls for managing the balance of payments crisis.

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[1] Comprehensive reviews of India's foreign trade and external sector since independence are given in Hajra and Sinate (1997) and Kapur (1997). Srinivasan (1999) provides a phase chronology of the Indian foreign trade regimes from 1950 to 1991.

Hence, during the latter part of the 1950s, import substitution was considered a major part of India's trade and industrial policies. The strategy of import substitution was adopted in view of the adverse trading environment, the limited possibility of expanding import purchasing power through exports and the objective of self-reliance. Thus, comprehensive import licensing was introduced that had 'indigenous clearance' as an important feature. Under this, automatic quota protection was provided to any imports for which domestic substitutes were available.

Foreign trade was not considered a stimulant to India's economic growth and policy makers underestimated the export possibilities. This is evident from a decline of the ratio of exports to GDP from 5.74 percent in the first half of the 1950s to 4.49 percent in the latter half of the 1950s (Table 2). Furthermore, in the latter part of 1950s, inflation in India was higher than inflation abroad and exports stagnated as a result of the appreciation of the real exchange rate (Joshi & Little, 1994). This also accounted for a decline in the ratio of exports to GDP as mentioned above. During the 1950s, the annual average growth rate for exports was 1.15 percent as compared to 6.9 percent for imports, a direct fallout of the development policy adopted during this period (Table 5).

In contrast to the 1950s, export promotion received attention in the 1960s. This was largely to offset the undesired consequences of quantitative restrictions on exports. In terms of the types of export promotion measures adopted, the 60s can be divided into three phases. In the first phase from 1962 through the middle of 1966, government introduced various subsidies for exports. The export subsidy extended during this period can be classified into the three categories of fiscal measures, import entitlement schemes and other promotional measures related to information dissemination on export opportunities and marketing development. Consequently, during the first half of the 60s, exports increased by 5.11 percent in nominal terms and 4.48

percent in real terms as compared to 1.7 percent and 2.22 percent respectively for the second half of the 50s. (Table 5).

In the second phase, during June 1966, the subsidies were replaced with the devaluation of the exchange rate. As a result, the nominal effective exchange rate declined by 24 percent and the real effective exchange rate by 18 percent, the lower real rate reflecting high levels of domestic inflation (Table 6). Devaluation was also accompanied by abolition of all the pre-devaluation export promotion schemes and reduction in tariffs. Further, export duties were imposed. In terms of performance, exports increased by 42 percent during 1966-67 in nominal terms when measured in domestic currency. However, in real terms exports declined by 4 percent (Table 5). This shows that the increase in export earnings in terms of domestic currency was solely because of the price effect of devaluation. This is also reflected in the change in the unit value index, which increased by 49 percent during 1966-67 (Table 4).

However, the expected effects of trade policy rationalization were not realized, as they were offset by the price increases induced by two successive droughts, their adverse impact on traditional exports and the onset of an industrial recession. Further, the removal of export subsidies and introduction of export taxes reduced the extent of net devaluation. This is reflected in the decline in export earnings (measured in US$ terms) by 2.1 percent during 1966-67 to 1967-68.

Soon after, modified schemes of the previously existing subsidies were reintroduced. Despite the devaluation and the subsequent reintroduction of export incentives, aggregate export earnings did not change substantially. During the latter half of the 60s exports increased by 2 percent in US$ terms, which was less than 5 percent for the first half of 60s.

In August 1971 the US dollar was no longer tied to gold. This brought an end to the era of fixed exchange rate regime. In the case of India, a pegged exchange rate regime was followed. The peg was initially to the US dollar (from August 1971 to December 1971) and later on to the floating Pound Sterling (till September 1975), which happened to be depreciating against the US dollar (Joshi & Little, 1994). The nominal effective exchange rate depreciated at an annual average rate of 4.74 percent during the first half of the 70s, whereas the real effective exchange rate depreciated by 2.74 percent during the same period (Table 6). Thus despite high inflation on account of severe droughts in 1972 and 1974, the sterling peg led not only to a nominal effective depreciation, but also to a real effective depreciation. Import controls were tightened in response to the oil price shock of 1973. However, increase in export incentives and depreciation in the real effective exchange rate helped boost India's exports during the first half of the 70s. As shown in Table 5, exports increased by 19 percent in nominal terms and 5.8 percent in real terms.

Effective September 1975, the Rupee was pegged to a basket of currencies of India's major trading partners. This change was on account of the downward pressure on the Pound Sterling vis-à-vis major international currencies following the breakdown of the Bretton Woods system. This resulted in the misalignment of the Rupee vis-à-vis other currencies. Another factor was a decline in the importance of UK in India's trade. The exchange rate was fixed by the Reserve Bank of India within a band of ± 2.25 percent with reference to a basket value base that was increased to ± 5 percent in January 1979. In 1976, the average annual fall in REER was 12.2 percent. This trend was reversed in 1980 when REER rose annually by almost 10.95 percent (Table 6). After that, external trade competitiveness improved in the 1980s as indicated by the decline in the REER.

Export performance improved in the 1970s and the ratio of exports to GDP (Table 2) increased from 3.35 percent in 1970-71 to 5.29 percent in 1979-80. Real exports grew especially in the second half of the 70s touching a high of 18.5 percent annualized growth rate in 1976-77 (Table 5). Importantly, while the exchange rate in nominal effective terms appreciated by 0.74 terms during the latter half of the 70s, in real effective terms it depreciated by 1.14 percent (Table 6). This increased the price competitiveness of Indian goods in the world market. There were two changes in the policies adopted in the 1970s. First, the coverage of export promotion measures was increased. Second, in the late 1970s, there was some import liberalisation that enabled shifts of some items from the restricted list to the open general license list. The buoyancy in world trade also helped to increase India's foreign trade although India's share in world exports dropped from 0.68 percent in 1970 to 0.45 percent in 1980 (Table 1).

During the early eighties, oil prices increased sharply and the overall conditions were not conducive to international trade and foreign aid. Since the mid eighties, however, a more active exchange rate policy was implemented. Further, the 1980s experienced severe pressures on balance of payments. Due to the two oil shocks in the 1970s, the terms of trade deteriorated significantly (Table 4) and the growth in real exports (quantum index) was less than 2% in the beginning of the 1980s whereas real import growth was close to 20% (Table 5). The pressure on balance of payments soon eased mainly as a result of moderation in imports. The growth in exports remained low until the mid 80s due to the slow recovery of world demand. The ratio of exports to GDP declined from 5.2 percent in the second half of the 70s to 4.6 percent in the first half of the 80s (Table 2). The 80s also witnessed a change in the policy stance towards the exports sector. In the 70s some measures of export promotion were undertaken but generally export pessimism prevailed. In the 80s, a cautious optimism of the export potential set in, perhaps due to the robust performance of exports in the 70s. Consistent with the ‘growth-led exports’ notion, the policy response was positive. Changes in the rules for import licensing facilitated imports of capital goods and other quality imports for export production at competitive prices. Further, the exchange rate was adjusted frequently to maintain international competitiveness.

Systematic liberalisation measures were introduced in the second half of 80s. These covered gradual relaxation of the rigours of quantitative restrictions (e.g. increased foreign exchange allocation for imports, procedural simplifications etc. while maintaining a quantitative restrictions based administrative system). Furthermore, attempts were made to reduce administrative delays associated with imports and exports. In terms of performance, exports and imports increased in real terms by almost 8 percent each respectively. In nominal terms, exports and imports increased by 11.6 percent and 8.2 percent per annum in US$ terms (Table 5). This was on account of a cumulative depreciation in the real effective exchange rate to the extent of 32 percent during 1984 to 1991 compared to almost 10 percent appreciation in the previous five years (Table 6). Furthermore, there was a significant pick up in the volume of world exports following the adjustment of the world economy to the two oil shocks.

However, in the second half of the 1980s, pressure on balance of payments increased culminating in the unprecedented payments crisis at the start of the 90s. Imports in real terms grew between 1985-90, especially in the first two years (Table 5) before a temporary dip in 1987-88. At the same time external indebtedness increased sharply and the debt service ratio accelerated between 1989-92 (Table 3).

In the year 1990-91, the Indian economy suffered an unprecedented external payments crisis. By then, the debt-service ratio had increased to over 35 percent. Further, the Gulf crisis of August 1990 resulted in a big increase in the oil import payments. There was also a large fall in workers' remittances from the Gulf region. With the increase in domestic uncertainty and the downgrading of sovereign credit ratings, international creditors did not roll over loans. At the same time, net inflows into non resident deposits diminished and there was a huge depletion of reserves. These problems prompted the package of structural reforms that was adopted in July 1991.

The reforms of 1991 resulted in a downward adjustment in the exchange rate as reflected in over 19 percent decline in NEER in 1991. Major reforms in trade and industrial policies were adopted that abolished licensing and favoured an increase in exports. Finally, exports growth picked up between 1993-96 substantially before slowing down in 1996-97 (Table 5). The share of exports to GDP rose from 5.73 percent in 1990-91 to 9 percent in 1995-96 (Table 2). Some of the factors explaining the slowdown in India's foreign trade in 1996-97 are the slowdown in world trade, sharp fall in international prices for manufactured goods and low economic growth in the industrialised countries (Hajra and Sinate, 1997).

With the enormous fluctuations experienced in the exports sector in the past, a key question is whether it is possible to provide an early warning signal for at least some of these changes. This study aims to create such a signal for the movements in the exports sector.