CHAPTER-II

THEORIES OF INTERNATIONAL TRADE

AND

ECONOMIC REFORMS IN INDIA

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2.1 INTRODUCTION

International trade is the exchange of goods and services across international borders. Imports and exports are the major sectors of international business. Imports and exports take place because of the felt needs of the country. In most countries, it represents a significant share of national income. While international trade has been present throughout much of history, its economic, social, and political importance have been on the rise in recent years, mainly because of Industrialization, advanced transportation, Globalization, the spread of Multinational corporations, and the phenomenon of outsourcing. In fact, it is probably the increasing prevalence of international trade that is usually meant by the term "globalisation". There are number of factors responsible for international trade such as difference in labour cost, interest on capital, availability of capital, raw materials etc.

In this chapter, a two-part analysis has been attempted. In the first part, following the introduction, an explanation regarding why trade takes place is provided and in the second part, the reforms pertaining to external sector that was introduced in India has been described. This is because government's attitude towards foreign trade is also an important factor that determines whether trade between two nations expands or not.[12]

It is pertinent here to note that the two extreme states or conditions could potentially be created by national government policies. At one extreme, government could pursue a "laissez faire" policy with respect to trade and thus impose no regulation whatsoever that would impede (or encourage) the free voluntary exchange

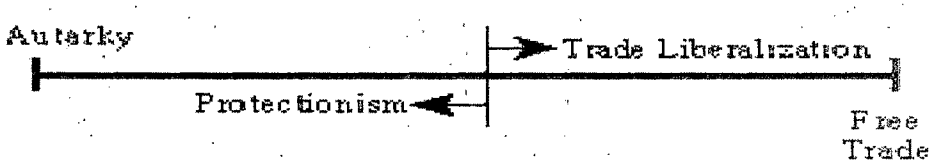


Figure-1

[12] It is this recognition that lead to the opening of external sector in India since 1991.

of goods between nations. This condition is defined as free trade. At the other extreme, government could impose such restrictive regulations on trade as to eliminate all incentive for international trade. This condition is defined as national autarky. Autarky represents a state of isolationism. (See, Figure 1).

In the figure, arrow to the left indicates that Government policies are promoting protectionism while the right arrow shows that the policies are promoting libralisation that is towards free trade. Probably, a pure state of free trade or autarky has never existed in the real world. All nations impose some form of trade policies. Moreover, probably no government has ever had such complete control over economic activity as to eliminate cross-border trade entirely. The real world, instead, consists of countries that fall somewhere between these two extremes.

2.2 THEORIES OF INTERNATIONAL TRADE

Number of theories have been developed to explain why nations trade. In the section that follows, these theories have been described.

2.2. a. Mercantilism:

One of the earliest attempts to describe the function of international trade is known as "Mercantilism". Mercantilism was developed in the 16th century. It insisted that the acquisition of wealth, particularly wealth in the form of gold, was of paramount importance for a nation. The trade policy dictated by mercantilist philosophy was accordingly simple. Encourage Exports, Discourage imports and take the proceeds of the resulting export surplus in gold.[13] Mercantilists took the virtues of gold almost as an article of faith. However, they never tried to explain adequately why the pursuit of gold deserved such a high priority in their economic plans. With its insistence on the accumulation of national wealth in the form of gold by encouraging exports, mercantilism was an inconsistent and ultimately self-defeating theory. Adam Smith attempted to formalize the theory to explain international trade in terms of absolute advantage.

[13] See, Allen, William R, (1987).

2.2. b. Absolute Advantage Theory:

Adam Smith has propounded the theory of absolute advantage in his book the "Wealth of Nations" published in 1776. Smith argued that countries differ in their ability to produce goods efficiently. He believed that the value of a product in a country is determined by its labour content.[14] Some countries have absolute advantage in the production of some goods, as labour cost is low in such countries. They can export such goods and import other goods for which labour cost is higher in the home country. The absolute advantage theory emphasized the importance of specialization as a source of increased output. Accordingly, each nation should specialize in the production of goods it is particularly well equipped to produce. It should export part of this production and import other goods that it cannot produce so cheaply. However, the theory fails to explain why trade takes place between two nations in which a country has absolute advantage in the production of all goods. Ricardo provided the answer in his theory of comparative cost advantage.

2.2. c. The Comparative Cost Theory:

David Ricardo noted economist illustrated the comparative cost theory by using the two countries, two-commodity model. Ricardo formulated this theory in his book "Principles of Political economy" published in 1817. In brief, the Comparative Cost theory explains that if trade is free, each country in the long run, will tend to specialize in the production and export of those commodities in whose production it enjoys a comparative advantage, and to obtain by import, those commodities which can be produced at home at a comparative disadvantage; and that such specialization is to the mutual advantage of the companies participating in it.[15] David Ricardo's illustration of the comparative cost theory shows that trade between nations can be profitable even if one of the two nations produces both commodities more efficiently than the other nation, provided that it can produce one of these

[14] See, Gide.C and Rist. C, (1945).
[15] See, Karl.E, Fair.C, (1999).

commodities with a comparatively greater efficiency than the other commodity. This theory is based on a few simplifying assumptions:

i. Labour is the only element of cost.

ii. Production is subject to the law of constant returns.

iii. International trade is free from all barriers.

iv. No transport cost.

The Comparative Cost theory has been severely criticized for its unrealistic assumptions. It should, however, be stated that the Comparative Cost Theory does provide some convincing explanation of the basis of international trade.

2.2. d. Reciprocal Demand Theory:

John Stuart Mill and other economists elaborated the classical position on trade further in the 20th century. J.S. Mill (1848) argued that the law of reciprocal demand sets the prices at which trade will take place. Reciprocal demand indicates a country's demand for one commodity in terms of the other commodity, which it is prepared to give up in exchange. Reciprocal demand determines the terms of trade and relative share of each country.

For example, Reciprocal demand means the strength of US demand for Indian textile and Indian demand for US wheat. This theory is also based on the assumption that free trade is allowed. However, the real world situation is different. Governments put regulations in trade in order to protect domestic industry and employment, correct imbalances in balance of payment etc. Trade between capital rich industrial countries and developing nations, which produce chiefly primary products, are conducted for many other reasons. The theory does not give guidance on this.

2.2. e. Factor Endowments Theory/ Modern Theory (Heckscher-Ohlin Theory):

Swedish economists Eli Heckscher (in 1919) and Bertil Ohlin (in 1933) are critical of the classical theory of comparative cost. They argued that classical theory does not explain why comparative cost differences take place. The classical theory demonstrated that the basis of international trade was the comparative cost difference. However, it did not explain the causes of such comparative cost difference. The alternative formulation of the comparative cost doctrine developed by Heckscher and Ohlin explains why a comparative cost difference exists internationally. They attribute international (and inter-regional) differences in comparative costs to:

(A) Different prevailing endowments of the factors of production; and
(B) The fact that the production of various commodities requires the factors of production are used with different degrees of intensity.

In short, it is the difference in factor intensities in the production functions of goods along with the actual differences in relative factor endowments of the countries, which explains the international differences in the comparative cost of production.

Thus, concisely, the Heckscher-Ohlin theory states that a country will specialize in the production and export of the goods whose production requires a relatively large amount of the factor with which the country is relatively well endowed with, capital only if the ratio of capital to other factors is higher than in other countries. The important assumptions of the model are:

1. Both the product and factor markets in both the countries are characterised by perfect competition.

2. The factors of production are perfectly mobile within each country but immobile between countries.

3. The factors of production are of identical quality in both the countries.

4. Factor supplies in each country are fixed.

5. The factors of production are fully employed in both the countries.

6. There is free trade between the countries, i.e. there are no artificial barriers to trade.

7. International trade is costless, i.e. there is no transport cost.

8. The factor endowments of one country vary from those of the other.

9. The techniques of producing identical goods are the same in both the countries because of this act; the same input mix will give the same quantity and quality of output in both countries.

10. Factor intensity varies between goods for instance; some goods are capital intensive (that is they require relatively more capital for their production). And some others are labor intensive (that is they require more labor for their production).

11. Production is subject to the law of constant returns; either input/output ratio will remain constant irrespective of the scale of the operation.

Most of the assumptions are obviously; unrealistic the Heckscher-Ohlin model has been criticised mainly for it is over simplifying and unrealistic assumptions.

However, Wassily W.Leontief's study has revealed that the USA, which is a capital rich country, imported capital-intensive goods and exported labour intensive goods. This has come to be popularly known as the Leontief's paradox, which is a negation of the Heckscher-Ohlin thesis.

2.2. f. The Availability Approach:

Another attempt to explain trade is in terms of the availability approach it explains the pattern of trade in terms of domestic availability and non-availability of goods. Availability influences operation through both demand and supply forces.

In short, the availability approach purports that a nation would tend to import those commodities, which are not readily available domestically and export those whose domestic supply can be easily expanded beyond the quantity needed to satisfy the domestic demand.

Kravis (1956) argues that Leontief's findings that the United States exports have a higher labour content and a lower capital content than its imports may be explained better and more simply by the availability factor. Goods that happen to have high capital content are bought abroad because they are not available at home. Some are unavailable in the absolute sense (e.g. diamonds); others in the sense that an increase in output may be achieved only at much higher costs (that is; the domestic supply is inelastic). When unavailability at home is due to lack of natural resources (relative to demand), the comparative advantage argument is perfectly adequate.

According to Kravis, there are other facts of the availability explanation of trade pattern that cannot be so readily subsumed under the rubric "comparative advantage". One of these is the effect of technological change. Historical data for the US indicate that exports have tended to increase most in those industries which have new or improved products that are available only in the US or in a few other places at the most. Product differentiation and government restrictions are the other factors tending to increase the proportion of international trade that represents purchases by the improving country of goods that are not available at home. Thus, According to Kravis, there are four bases of the availability factor, namely:

1. Natural resources
2. Technological progress
3. Product differentiation and
4. Government policy

The first three of the four bases—natural resources, technological progress and product differentiation- probably tend , on the whole , to increase the volume of international trade. The absence of free competition, a necessary condition for the unfettered operations of the law of comparative advantage, tends to limit trade to goods that cannot be produced by the importing country, argues Kravis. The most

important restrictions on international competition are those imposed by the governments and by cartels. Those imports that are unavailable or available only at a formidable cost are subject to the least governmental interfaces. Kravis is of the opinion that the quantitative importance of the availability factor in international trade is considerable. This appears to apply especially to half of world trade that consists of trade between the industrial areas on the one hand and the primary producing areas on the other.

The availability approach has, undoubtedly, considerable merit in its explanation of the pattern of trade.

2.2. g. The Product Life Cycle Theory (PLC):

Rymond Vernon initially proposed the product life cycle theory in the mid 1960's as basis for international trade. Vernon's (PLC) model, which concerns the stages of production of a product, with new expertise. The hypothesis of the model is that new products move through a cycle, or a series of stages, in the course of their development. The comparative advantage of the products changes as they move through one phase of cycle to another. Such a product is first produced by the parent firm, then by its foreign subsidiaries and finally anywhere in the world where costs are the lowest. The theory explains why a product that begins as a nations export ends up becoming an import. The PLC has three stages: New product, Maturing product and Standardised Product. A new product is an innovative one and consumption is in the home country. As years go by, product enters the mature phase of its life cycle and exporting started. Competitors try to introduce substitutes. As product enters standardised product stage, the technology becomes widely diffused and available. Production tends to be shifted to low-cost locations. The PLC theory predicts that initially, the comparative advantage will exist in the innovating country, but over time, as product becomes standardised the country of comparative advantage will shift to lower factor cost locations.

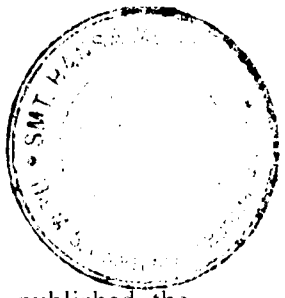
2.2. h. Technological Gap Model:

Posner (1961) formulated the Technological Gap model according to which a good deal of trade among industrialized countries takes place because of technological innovations. The technological innovations may be the introduction of a new product or a new productive process. The country, which makes innovation, gets monopoly through patents or copyrights. It exports those products to foreign countries. However, in course of time, technology is diffused, and the importing country starts domestic production. The innovator loses the foreign market and may turn into an importer of the very product it had exported. Such situation calls for continuous innovations by the countries. Posner's theory considers technological change as a continuous process with two time lags-imitation lag and demand lag. The essence of argument is that a continuous process of inventions and innovations would give rise to trade even between countries with similar factor endowments.

2.2. i. The Opportunity Cost Theory:

The Opportunity Cost theory, propounded by Professor Gotfried Haberler in 1983,has been applied to theory of international trade as a substitute for the doctrine of Comparative cost expressed in terms of labor cost or real cost.

The opportunity cost of any thing is the value of the alternatives or other opportunities, which have to be forgone in order to obtain that particular thing. According to opportunity cost theory, the basis of international trade is the differences between nations in the opportunity costs of production of commodities. As far as the basis of international trade and specialisation are concerned, the logic behind the comparative cost approach and the opportunity cost approach are the same. However, there is a notable difference in the treatment. Under the comparative cost approach, we measure the cost of producing a product in terms of labor or in terms of any real cost, but under the opportunity cost approach, the cost of producing a product is measure in terms of the amount of cloth foregone in order to produce one more unit of other product.



2.2. j. National Competitive Advantage:

In 1990, Michael Porter of Harvard Business School published the results of an intensive research work that attempted to determine why some countries succeed and others fail in international trade.

Porter's thesis is that four broad attributes of a nation shape the environment in which local firms compete, and these attributes promote or impede the creation of competitive advantage.

Determinants of National Competitive Advantage:

- Factor Endowments
- Demand conditions
- Firm Strategy, Structure and Rivalry
- Related and Supporting Industry

Porter's speaks of above four attributes as constituting the diamond. He argues that firms are most likely to succeed in industries or industry segments where the diamond is most favorable.

For an explanation why international trade takes place, Porter's theory is useful in as much as it suggests that countries should be exporting products from those countries where all four components of the diamond are favourable, while importing in those areas where the parts are unfavorable.

2.2. k. Krugman's Theory:

Krugman's explanation of trade between similar countries was proposed in a 1979 paper in the *Journal of International Economics*. This theory is considered one of the new theories of international trade. He assumed that consumers prefer a diverse choice of brands, and that production favors economies of scale. Consumers' preference for diversity explains the survival of different versions of cars like Volvo and BMW. But because of

economies of scale, it is not profitable to spread the production of Volvos all over the world; instead, it is concentrated in a few factories and therefore in a few countries (or maybe just one). This logic explains how each country may specialise in producing a few brands of any given type of product, instead of specializing in different types of products.

Most models of international trade nowadays follow Krugman's lead, incorporating economies of scale in production and a preference for diversity in consumption. This way of modeling trade has come to be called New Trade Theory. When there are economies of scale in production, it is possible that countries will become 'locked in' to disadvantageous patterns of trade. Nonetheless, trade remains beneficial in general, even between relatively similar countries, because it permits firms to save on costs by producing at a larger, more efficient scale, and because it increases the range of brands available and sharpens the competition between firms. Therefore, Krugman has usually been supportive of free trade and globalization, and critical of industrial policy.

In addition to economies of scale in production, Krugman's new theory is also based on an assumption that consumers appreciate diversity in their consumption. At the time, this was a rather new concept in economics, but it appeared to correspond to reality. Indeed, most of consumers have witnessed greater diversity in the supply of available commodities. As consumers, are constantly tempted by a growing number of brands, even though they might sense that a standard car, a standard pair of jeans or standard toothpaste would suffice. After our basic needs for food and housing have been satisfied, it seems as if we opt for diversity and variation in our consumption.

Avinash Dixit and Joseph Stiglitz (1977) had published a model for analysing consumers' preferences for product diversity. According to this model, each producer, working under increasing returns to scale, becomes more or less a monopolist in terms of his own brand, even though he is subject to sharp competition from other brands. Such a model can be used to show that foreign trade will arise not only between countries which are *different* (as in the traditional theory), but also between countries which are *identical* in terms of access to technology and factor endowments. Moreover, it can be

demonstrated that extensive intra-industry trade will occur. In fact, it becomes advantageous for a country to specialize in manufacturing a specific car, and to produce it for the world market, while another country specialises in a different brand of car. This allows each country to take effective advantage of economies of scale, thereby implying that consumers worldwide will benefit from greater welfare due to lower prices and greater product diversity, as compared to a situation where each country produces solely for its own domestic market, without international trade.

Krugman's initial article is brief and straightforward. Owing to its simplicity, the international research community could quickly ascertain that it pointed to vital mechanisms in the economy. In many subsequent articles and books, Krugman himself, as well as other researchers, have endowed the theory with greater realism. Today, the general view is that the basic mechanisms specified by Krugman constitute an important complement to the traditional Heckscher-Ohlin theory. The truth, as in so many other instances, is that reality encompasses features of both theories. This has resulted in lively empirical research aimed at determining the extent to which foreign trade can be explained by the earlier theories as compared to the new theory. In general, the new theory of international trade has inspired an enormous field of research, which is usually a reliable indication of theoretical quality.

An overview of the different theories of international trade leads one to conclude that there are number of factors responsible for expansion of international trade. It is also certain that government policy plays an important role in expanding trade between nations. It is in this context that in the next section Indian reforms have been described.

2.3 INDIAN REFORMS

2.3. a. Background:

At the outset of independence, the strategic objective of Indian policy makers was to create a self-reliant economy and the reduction of the high levels of poverty that existed, within a democratic political framework. In

order to achieve these objectives, the authorities steadfastly pursued a Socialist strategy of state-directed, heavy industry based industrialisation complemented by an across-the-board import substitution policy, financial repression and complex industrial requirements.[16] Notwithstanding some notable successes, the highly statist and interventionist development policies adhered to during this period of insulation led to a severely distorted production structure. While growth did pick up in the latter half of the 1970s, the Indian economy was generally mired in a vicious circle of low productivity/product obsolescence and slow growth. Not only was the performance of the Indian economy well below the targets set by the planning authorities, the country was left lagging in terms of economic growth and development relative to its East Asian neighbours such as China and Korea, which had broadly similar levels of per capita income at the time of India's independence (Kelkar, 2001).[17] Although some tentative steps were taken in 1985 for first time to liberalise and unshackle the economy by delicensing a few industries, these partial and rather *ad hoc* measures contributed to the creation of severe and unsustainable macroeconomic imbalances in the Indian economy, particularly with regard to escalating fiscal deficits.[18] The imbalances corresponded to a period of severe political instability and uncertainty following three successive minority governments during 1989–91. While the fragilities in the Indian economy were largely homemade, the shock of the 1990 Gulf war was the single most factors, which "broke the camel's back" as India was brought to the brink of an international default. Following this, the country plunged into a deep economic crisis. The rate of inflation rose to a level much higher than what India had witnessed even six months earlier. Foreign exchange reserves declined to about $1 billion at the end of the financial year 1990/91, a level covering only three weeks of imports, something that had never occurred in its post-independence history.

Faced with a severe balance of payments crisis of foreign exchange reserves, India entered into an IMF influenced structural adjustment program.

[16] See, Government of India, Second five-year plan, (New Delhi,-1956)
[17] See, Kelkar, (2001)
[18] See, Wadhva, Charan D (2003).

In addition to the conventional expenditure switching and reducing policies, as part of the IMF agreement, a range of far-reaching economic policy reforms was launched in July 1991 in the external, industrial, financial and public sectors.

The reforms in the 1990s, mainly dealt with industry and trade policy. These policy do have its impact on the economy in general and external sector in particular, in view of this, it is essential to examine, effect of the reforms on the instability of the external sector variables like exports, imports , terms of trade etc.[19]In the next section, the industrial policy changes will be looked at. This will be followed by trade policy.

2.3. b. Industrial Policy:

With most central government industrial controls, being dismantled Industrial policy has seen the greatest change. The list of industries reserved solely for the public sector-, which used to cover 18 industries, including iron and steel, heavy plant and machinery, telecommunications and telecom equipment, minerals, oil, mining, air transport services and electricity generation and distribution- has been drastically reduced to just three: defense aircrafts and warships, atomic energy generation, and railway transport. Industrial licensing by the central government has been almost abolished except for a few hazardous and environmentally sensitive industries. The requirement that investments by large industrial houses needed a separate clearance under the Monopolies and Restrictive Trade Practices Act to discourage the concentration of economic power was abolished and a new competition law, which aims to regulate anticompetitive behavior in other ways, has replaced the act itself.

The main area where action has been inadequate relates to the long-standing policy of reserving production of certain items for the small-scale

[19] The costs imposed by these policies had been extensively studied (Bhagwati and Desai, 1965; Bhagwati and Srinivasan, 1971; Ahluwalia, 1985) and by 1991, a broad consensus had emerged on the need for greater liberalization and openness.

sector.[20] About 800 items were covered by this policy since the late 1970s, which meant that investment in plant and machinery in any individual unit producing these items could not exceed $ 250,000. Many of the reserved items such as garments, shoes, and toys had high export potential and the failure to permit development of production units with more modern equipment and a larger scale of production severely restricted India's export competitiveness. The Report of the Committee on Small Scale Enterprises (1997) and the Report of the Prime Minister's Economic Advisory Council (2001) had both pointed to the remarkable success of China in penetrating world markets in these areas and stimulating rapid growth of employment in manufacturing.[21] Both reports recommended that the policy of reservation should be abolished and other measures adopted to help small-scale industry. While such a radical change in policy was unacceptable, some policy changes have been made. After which the products, which are still reserved for Small Scale Enterprises, has come down to 35 by 2008.[22] In addition, the investment ceiling for certain items was increased to Rs 5crore. However, these changes are very recent and it will take some years before they are reflected in economic performance. It is this policy that has boosted Indian export performance

Industrial liberalisation by the central government needs to be accompanied by supporting action by state governments. Private investors require much permission from state governments to start operations, like connections to electricity and water supply and environmental clearances. They must also interact with the state bureaucracy in the course of day-to-day operations because of laws governing pollution, sanitation, workers' welfare and safety, and such. Complaints of delays, corruption and harassment arising

[20] The policy of reservation of items for manufacturing in SSI was introduced in 1967, which received a proper statutory backing in 1984 through amendment in Industries (Development and Regulation) Act 1951. Initially only 47 items were reserved in 1967, which went up to 873 in 1984. The total number of items on the reserved list has been coming down year to year like 14 items were dereserved on June 29, 2001 related to leather goods, shoes and toys. 51 items were dereserved in May 2002, 125 items were dereserved on March 13, 2007, reducing the number of items reserved to 114 and 79 items were dereserved on Feburary 5 , 2008 , reducing the number of items reserved to 35.

[21] See, Economic Survey, 2001-02, p.181

[22] See, Economic Survey, 2007-08, p.199

from these interactions are common. Some states have taken initiatives to ease these interactions, but much more needs to be done.

2.3. c. Trade Policy:

Economic integration through trade and investment has now become the dominant development strategy in the world, and a similar strategy has been pursued by India for the last one and a half decades. The explicit goals of the economic reform strategy in India after 1991 with respect to the external sector, were to create a major shift in the momentum of export growth, and to attract very large inflows of foreign capital (particularly in the form of export-oriented FDI) to augment domestic savings and therefore allow much higher rates of gross domestic investment .

Trade policy reform has also made progress, though the pace has been slower than in industrial liberalisation. Before the reforms, trade policy was characterised by high tariffs and pervasive import restrictions. Imports of manufactured consumer goods were completely banned. For capital goods, raw materials and intermediates, certain lists of goods were freely importable, but for most items where domestic substitutes were being produced, imports were only possible with import licenses. The criteria for issue of licenses were non-transparent; delays were endemic and corruption unavoidable. The economic reforms sought to phase out import licensing and also to reduce import duties.

Import licensing which had been traditionally defended on the grounds that it was necessary to manage the balance of payments was abolished by 1993 relatively early for capital goods and intermediates also became freely importable. There was a switch to a flexible exchange rate regime. This shift to a flexible exchange rate enabled the government to argue that any balance of payments impact through import licensing abolition would be effectively dealt with through exchange rate flexibility. Removing quantitative restrictions on imports of capital goods and intermediates was relatively easy, because the number of domestic producers was small and Indian industry welcomed the move as making it more competitive. It was much more

difficult in the case of final consumer goods because the number of domestic producers affected was very large (partly because much of the consumer goods industry had been reserved for small-scale production). Quantitative restrictions on imports of manufactured consumer goods and agricultural products were finally removed on April 1, 2001; almost exactly ten years after the reforms began.[23] This was consequence of WTO ruling.[24] Thus, trade reforms lowered tariffs and removed barriers on imports. This increased import competition for traded goods made firms to rationalise their input decisions. This enhanced the productivity of Indian manufacturing and permitted them to not only stay competitive in the new environment but also become competitive globally. In addition to the above many sectors were also opened up for Foreign Direct Investment (FDI) and higher equity participation. As FDI and international trade have a two-way link, in the section that follows India's FDI policy is described.[25]

i. **Foreign Direct Investment**: Liberalising foreign direct investment was another important part of India's reforms, driven by the belief that this would increase the total volume of investment in the economy, improve production technology, and at the same time increase access to world markets. The policy now allows 100 percent foreign ownership in a large number of industries and majority ownership in all except banks, insurance companies, telecommunications and airlines. Procedures for obtaining permission were greatly simplified by listing industries that are eligible for automatic approval up to specified levels of foreign equity (100 percent, 74 percent and 51 percent).[26] Potential foreign investors investing within these

[23] See, Economic Survey, 2001-02, p.142

[24] Article XI of GATT provides for the general elimination of Quantitive Restrictions (QRs) on imports stipulating that imports may be controlled only through tariffs. Non-tariff barriers or QRS on India's imports have been progressively liberalized. From a level of 61 percent tariff lines being free to import as on 1. 4.1996, the share of tariff lines without restrictions has increased to around 95 per cent on 1.4.2001. QRs are, however, still being maintained on about 5 per cent of tariff lines (538 items) as permissible under Article XX and XXI of GATT on ground of health, safety and moral conduct.

[25] See, Nagesh Kumar, (1994).

[26] See, Economic Survey, 2001-02, p.155

limits only need to register with the Reserve Bank of India.[27] For investments in other industries, or for a higher share of equity than is automatically permitted in listed industries, a Foreign Investment Promotion Board that has established a record of accomplishment of speedy decisions considers applications. In 1993, foreign institutional investors were allowed to purchase shares of listed Indian companies in the stock market, opening a window for portfolio investment in existing companies.

These reforms related to FDI have created a very different competitive environment for India's industry than that existed in 1991. Indian companies have upgraded their technology and expanded to more efficient scales of production. They have also restructured through mergers and acquisitions and refocused their activities to concentrate on areas of competence. New dynamic firms have displaced older and less dynamic ones: of the top 100 companies ranked by market capitalization in 1991, about half are no longer in this group. It also led to an appreciable increase in FDI both in gross and net basis.[28]

ii. Liberalisation of Trade in Services: Since 1991, India has also carried out a substantial liberalisation of trade in services. Traditionally, services sectors have been subject to heavy government intervention. Public sector presence has been conspicuous in the key sectors of insurance, banking, and telecommunications. Nevertheless, considerable progress has been made toward opening the door wider to private-sector participation, including participation by foreign investors. Until recently, insurance was a state monopoly. On December 7, 1999, the Indian Parliament passed the Insurance Regulatory and Development Authority (IRDA) Bill, which established an Insurance Regulatory and Development Authority and opened the door to private entry including foreign investors. Up to 26 percent foreign investment, subject to obtaining license from the Insurance Regulatory and Development Authority, is permitted. Though the public sector dominates in the banking

[27] Government has permitted , except for a small negative list, access to the automatic route for FDI, whereby foreign investor only need to inform the RBI within 30 days of bringing in their investment, and again with in 30 days of issuing any share.

[28] On a gross basis , the growth in 2006-07 was 150.2 per cent , on a net basis it was 179.2 per sent (Economic survey – 2007-08, pp.123)

sector, private banks are permitted to operate in it. Foreign direct investment (FDI) up to 74 percent in the private banks is permitted under the automatic route. In addition, foreign banks are allowed to open a specified number of new branches every year. More than 25 foreign banks with full banking licenses and approximately 150 foreign bank branches are in operation presently. Under the 1997 WTO Financial Services Agreement, India committed to permitting 12 foreign bank branches annually. The telecommunications sector has experienced much greater opening to private sector including foreign investors. Until the early 1990s, the sector was a state monopoly. The 1994 National Telecommunications Policy provided for opening cellular as well as basic and value-added telephone services to the private sector with foreign investors granted entry. Rapid changes in technology led to the adoption of the New Telecom Policy in 1999, which provides the current policy framework. Accordingly, in basic, cellular mobile, paging and value added service, and global mobile personnel communications by satellite, FDI is limited to 49 percent subject to grant of license from the Department of Telecommunications. FDI up to 100 per cent is allowed with some conditions for Internet service providers not providing gateways (both for satellite and for submarine cables), infrastructure providers providing dark fiber, electronic mail, and voice mail. Additionally, subject to licensing, security requirements, and the restriction that proposal with FDI beyond 49 per cent must be approved by the government, up to 74 percent foreign investment is permitted for Internet service providers with gateways, radio paging, and end-to-end bandwidth. FDI up to 100 percent is permitted in e-commerce.[29] Automatic approval is available for foreign equity in software and almost all areas of electronics. One hundred percent foreign investment is permitted in information technology units set up exclusively for exports. These units can be set up under several schemes, including Export Oriented Units (EOUs), Export Processing Zones (EPZs), Special Economic Zones (SEZs), Software Technology Parks (STPs), and Electronics Hardware Technology Parks (EHTPs).[30] The infrastructure sector has also been opened

[29] See, Economic Survey, 2001-02, p.155

[30] Exports from SEZs have been showing steady increase. As compared to exports of Rs. 22,840 crore made by SEZs in 2005-06, exports to the tune of

to foreign investment. FDI up to 100 percent under automatic route is permitted in projects for construction and maintenance of roads, highways, vehicular bridges, toll roads, vehicular tunnels, ports, and harbors. In construction and maintenance of ports and harbors, automatic approval for foreign equity up to 100 percent is available. In projects providing supporting services to water transport, such as operation and maintenance of piers, loading, and discharging of vehicles, no approval is required for foreign equity up to 51 percent. FDI up to 100 percent is permitted in airports, with FDI above 74 percent requiring prior approval of the government. Foreign equity up to 40 percent and investment by nonresident Indians up to 100 percent is permitted in domestic air-transport services. Only railways remain off limits to private entry. Since 1991, several attempts have been made to bring private sector, including FDI, into the power sector but without perceptible success. The Electricity Bill 2003 replaces the three existing power legislations dated 1910, 1948, and 1998. The bill offers a comprehensive framework for restructuring the power sector and builds on the experience in the telecommunications sector. It attempts to introduce competition through private sector entry side by side with public-sector entities in generation, transmission, and distribution. The bill fully delicenses generation and freely permits captive generation. Only hydro projects would henceforth require clearance from the Central Electricity Authority. Distribution licensees would be free to undertake generation and generating companies would be free to take up distribution businesses. Trading has been recognized as a distinct activity with the Regulatory Commissions authorized to fix ceilings on trading margins, if necessary. FDI is permitted in all three activities.[31]

It is in the light of the above steps taken by the government towards the liberalisation that in the next chapter an attempt is made to examine the impact of these steps on the Indian economy in general and specifically on the external sector.

Rs.34,615 crore have been effected in the year 2006-07, registering a growth of 52 per cent.

[31] As a result of the comprehensive review of the FDI policy, wide –ranging policy changes were notified in 2006, extending automatic routes, increasing equity caps, removing restrictions, simplifying procedures and extending the horizon of FDI to vistas like single brand product retailing and agriculture.