UNIT 18 FOREIGN TRADE AND BALANCE OF PAYMENT

Structure

18.0 OBJECTIVES

After going through this unit, you will be able to:

- state the role of foreign trade in economic development of a country;
- evaluate the changes in the structure of India's Foreign Trade;
- assess India's position of balance of payment;
- outline the policy framework for restoring equilibrium in balance of payments.

18.1 INTRODUCTION

India is moving fast towards globalisation. Inter-dependence between the economies of the world has increased multifold. External sector in the economy has gained prime importance. Both exports and imports contribute to the production process. Both of these are effective instrument in raising the income levels of the people in a developing economy. Apart from flow of goods, increasing flows of services and capital between the nations give rise to payments and receipts in foreign exchange which, in turn, influence the Balance of Payment's position. In this unit, we shall examine the various issues related to foreign trade and Balance of Payments. Let us begin with explaining the relationship between foreign trade and economic growth.

18.2 TRADE AND ECONOMIC DEVELOPMENT

Foreign trade has worked as an '*engine of growth*' in the past (witness Great Britain in the 19^{th} century and Japan in the 20^{th}, besides others), and even in more recent times the "outward-oriented growth strategy" adopted by the Newly Industrialising Economies of Asia, viz., Hong Kong, (now a special administered area of China), Singapore, Taiwan, Malaysia, Thailand, and South Korea, has enabled them to overcome the constraints of small resource-poor under-developed economies.

Contribution of Foreign Trade to Economic Development

Foreign trade contributes to economic development in a number of ways.

- It provides flow of technology which allows for increases in total factor productivity, and some short-run multiplier effects for countries with unemployed labour.
- It generates pressure for dynamic change through: (i) competitive pressure from imports, (ii) pressure of competing for export markets, and (iii) a better allocation of resources.
- Exports allow increased exploitation of economies of scale, separation of production pattern from domestic demand, and increasing familiarity with absorption of new technologies.
- These, in turn, help increase the profitability of the domestic business without any corresponding increase in price.
- Foreign trade increases most workers' welfare. It does so at least in four ways: (i) larger exports translate into higher wages; (ii) because workers are also consumers, trade brings them immediate gains through cheaper imports; (iii) it enables most workers to become more productive as the goods they produce increase in value; and (iv) trade increases technology transfers from industrial to UDCs and the transferred technology is biased in favour of skilled labour.
- Increased openness to trade has been strongly associated with the reduction of poverty in most developing countries, as the historian Arnold Toynbee said '*civilisation*' has been spread through 'mimesis': simple copying.

A proper analysis of a country's foreign trade can be attempted in its three component parts, viz., (i) Volume of trade, (ii) Composition of trade, and (iii) Direction of trade.

18.2.1 Volume of Trade

It relates to the size of international transactions. Since a large number of commodities enter in international transactions and their aggregate can be found only by finding their money value, the volume of trade can be measured by finding the value. The trends in the value of trade help to identify the basic forces that may be operating at different periods in the economy.

However, mere absolute changes in the value of trade may not be satisfactory guide, hence it is necessary to find the changes in the value of trade by relating them to two variables, viz.,

- Share of exports/imports in GDP, and
- Share of exports/imports in world trade.

The share of exports/imports in GDP indicates the degree of outward-orientation or openness of the economy in regard to the trade activity. This share reflects in a broad way the nature of trade strategies adopted in the country. The ratio of exports to GDP could be interpreted also to mean supply capability of the economy in regard to exports. It can be called as average propensity to export. The similar ratio between imports and GDP gives the average propensity to import. Clearly, however, the appropriate share of exports in output under an efficient allocation of resources will be less in bigger economies than in smaller economies.

The share of exports in the world trade indicates the importance of the country as a nation in the world economy. It reflects the market thrust that the country is able to realise in presence of the various competitors in the world market. Changes in this ratio, thus, indicate the shift in the position of the comparative advantage of the country.

Further, changes in the value of exports may be compared to the changes in the value of imports. The relationship between these two variables is known as the *terms of trade (TT)*, i.e., the terms at which exports exchange for imports; if the exports value in terms of imports value shows an increase, the TT are said to be favourable. Favourable TT imply that for a given value of exports, the country can produce more of imports. Conversely, if the TT are unfavourable a country has to give up more exports to produce a given volume of imports.

18.2.2 Composition of Trade

It is indicative of the structure and level of development of an economy. For instance, most of the UDCs depend for their export earnings on a few primary commodities (PCs); these countries export raw materials of agricultural origin and import manufactured industrial products, thus, denying themselves the benefits of value added. As an economy develops, its trade gets diversified. It no more remains dependent on a few PCs. It begins to export more of manufactured industrial goods and import industrial raw materials, capital equipment and technical know-how.

Manufactured exports create greater value addition than PCs as they go through more stages of processing. The manufacturing sector has greater linkages with the rest of the economy and, hence, the downstream effect on exports from these sectors are likely to be greater than primary exports.

The commodities entering trade could also be classified by various other criteria such as value added per unit of output, productivity of labour, capital intensity in production, strength of backward and forward linkages, etc.

The shifts in the commodity composition of trade in these categories would bring out the nature of structural changes in regard to income generation, employment effect and overall industrialisation through linkages effects, etc.

The following questions need to be analysed in this regard:

- What is the degree of concentration in the composition of exports/imports? Has there been any change in the degree of concentration over time?
- Is there any shift in the shares of the primary products and manufactured products in the total export or import trade?

18.2.3 Direction of Trade

It is indicative of the structure and level of economic development. As a country develops and its trade gets diversified, it has to seek new outlets for its exports. Its horizon of choice in terms of imports also gets widened. The country begins to trade with an increasingly large number of countries. In this regard, one could ask whether there has been a concentration or dispersion of the markets for exports and sources of supply for imports.

It is in terms of these components that we have to study the trends in India's foreign trade during the course of economic planning.

Check Your Progress 1

1) How do exports contribute to the process of economic development?

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2) How does growth of an economy affect the volume of its foreign trade?

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3) What type of changes are observed in the direction of trade as an economy experience growth?

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18.3 VOLUME OF INDIA'S FOREIGN TRADE

Prior to economic reforms, promotion of import substitution and discouraging of exports affected the nature and composition of trade. Imports were largely of machinery, equipment and intermediates in production. As the Indian economy grew, imports of petroleum and petroleum-products also grew. With the Green Revolution from the early 1970s and until India set up its own fertilizer units, imports of fertilizer too were an important part of the composition of imports. What was substantially missing from imports was consumer goods of different types, including luxury consumer goods and consumer durables.

Even before 1991, India's exports were diversifying. Beginning with an overwhelming agricultural composition of exports (tea, raw cotton) with the diversifying industrial structure, promoted by import substitution, exports of manufactures were growing. But the real push to increasing exports of manufactures came with the reforms from mid-1980s to 1991.

Table 18.1 shows the growing role of India's external trade, exports and imports. In the immediate five-year period preceding the 1991 reforms, external trade formed only 13.40 per cent of the GDP. During the 1990s and the first decade of the current century this share has been continuously rising as would be seen from Table 18.1.

Table 18.1: Share of exports and imports in India's GDP (per cent)

Year Annual Average	Exports	Imports	Total External Trade
1985-90	5.10	8.30	13.40
1990-95	7.81	9.51	17.32
1995-00	8.50	12.04	20.54
2000-01	9.9	12.6	22.5
2009-10	13.2	21.7	34.9
2010-11	14.5	23.2	37.7

Source: RBI, Annual Report, 2010-11.

In absolute terms, India's foreign trade has grown to exports of $250 billion and imports of $380 billion in 2010-11. But it is more useful to see trade volume as a per centage of GDP. As shown in Table 18.1 the ratio of exports plus imports to GDP has grown from 13.40 per cent in the five-year period 1985-90 to almost three times that, being 37.7 per cent in 2010-11. If we add trade in services to trade in goods, then the ratio goes up from 22.9 per cent in the 1990s to 49.0 per cent in 2010-11 (see Table 18.2). Trade clearly is a growing feature of the Indian economy.

Table 18.2: Volume of India's trade (in US billion $).

Current Account	Years		
	2008-09	2009-10	2010-11
Exports	189.00	182.23	250.46
Imports	308.52	300.60	380.93
Trade Balance	–119.52	–118.37	–130.46
Invisible, net	91.60	79.99	85.18
of which			
a) Software services	46.30	49.70	59.00
b) Private transfers (remittances)	44.56	52.05	53.36

Source: RBI, Annual Report, 2010-11, Appendix Table 18.

Looking at trade Table 18.2, some interesting points emerge. First is that India has a large deficit in the classical trade in goods, such as agricultural products, minerals, metals and manufactures. This large deficit is accounted for by high imports of capital goods and of petroleum and its products. But exports are clearly lagging behind the growth in imports.

However, the picture is changed by the role of what is called 'invisibles'. This includes both services, mainly software services, export of which has grown to \$59 billion in 2010-11. Along with this, remittances from Indians abroad at \$53 billion in 2010-11 is almost as much. This brings the current account deficit from \$130 billion to \$44. This deficit is quite easily covered by the capital account surplus of \$59 billion in that year.

However, the large current account in goods trade is a matter of concern and the government has come up with a New Foreign Trade Policy to increase exports and reduce the trade deficit.

It must be acknowledged that India is a 'big player' only in the field of IT service exports, but not in the crucial area of manufacturing exports. We call manufacturing exports crucial because, unlike IT service, it can generate a large volume of employment. However, in this area, India's trade policy has not been much of a success. There has been some success in increasing the share of manufacturing, as we will see below. However, this is nothing like the spectacular performance of China and South-east Asia which have become the manufacturing centre of the world.

18.4 COMPOSITION OF INDIA'S FOREIGN TRADE

The composition of India's external trade has been changing. In the early decades after Independence, exports were mainly of primary goods, viz. agricultural commodities and raw materials, such as minerals. Over time, the role of manufactures including engineering goods has been increasing. Overall manufactured goods are as much as 66 per cent of total exports, of which engineering goods contribute as much as 27 per cent of the value of goods exported. These engineering goods include automobiles and parts, agricultural machinery, and electrical machinery.

The exports that have not grown as much as would be expected, given India's status as a labour abundant economy, are textiles and textile products, which include garments and leather products. They still account for just a little more than 10 per cent of India's exports.

In some cases, it is useful to look at both imports and exports together. For instance, India imported \$106.06 billion of petroleum, mainly crude oil. This crude oil was refined and turned into various petroleum products, such as lubricants, fiber, etc. Similarly, gems and jewellery show a high value of \$40.79 billion. Here too there is a high import content, in the value of raw diamonds and precious stones imported. In both cases, raw materials are imported, processed in India and then exported. In petroleum products the processing is of a high-tech variety, in refineries with high capital and low labour content. In jewellery, it is mainly low-tech, with a high labour content in cutting and polishing of precious stones.

The above examples show up a problem with trade statistics — we cannot take the value of exports at face value. From this we should deduct the value of the raw materials imported. This will then give a better measure of the contribution of that item to the Indian economy – it will give the value added that is India's gain.

Table 18.3: India's Exports and Imports (US$ billion).

	2007-08	Per cent share	2010-11	Per cent share
Exports				
1) Primary Products	27.55	16.91	35.35	13.89
a) Agricultural and Allied	18.43	11.31	24.69	9.70
b) Ores and minerals	9.11	5.59	10.66	4.19
2) Manufactured Goods	102.97	63.21	168.09	66.07
a) Leather & Manufactures	3.50	21.48	3.78	1.48
b) Chemicals and related	21.19	13.00	28.79	11.31
c) Engineering goods	19.42	11.92	23.31	9.16
d) Textiles and products	19.42	11.92	23.31	9.16
e) Gems & jewelry	19.67	12.07	40.79	16.03
f) Handicrafts	0.50	0.30	0.23	0.09
3) Petroleum products	28.36	17.40	41.91	16.47
Total exports	162.90		254.40	
Imports				
1) Bulk imports	112.74	44.83	150.48	42.60
a) Petroleum	79.64	31.67	106.06	30.08
2) Non-bulk Imports	138.69	55.16	202.08	57.31
a) Capital goods	70.11	27.88	71.62	20.31
b) Mainly export related	20.76	8.25	49.63	14.07
Total Imports	**251.43**		**352.57**	

Source: RBI, Annual Report, 2010-11, Appendix Table 17, p. 186.

It should be noted that we have used data of imports and exports, FDI etc. in US $ terms. These data could also be given in Indian Rupee terms. But with the exchange rate between the Indian Rupee and the US Dollar fluctuating, an Indian Rupee figure will not be a good measure of the role of these traded sectors in the Indian economy. The value of exports and imports are better stated in international currency terms. Most international transactions, including for petroleum, are carried out in US dollar terms.

Summarising the role of the external or internationally traded goods sector, it can be said that its role in the Indian economy has been growing steadily, if not as rapidly as in the case of the East and South-east Asian economies. At present imports and exports together account for up to 49 per cent of India's GDP, as against 18.8 per cent in over the decade of the 1990s.

For India, however, export earnings do not only come from sales of goods. They also come from sales of services. These services are basically IT software services and also what are called IT-enabled services (ITES). Together they earned as much as $59 billion in 2010-11 (see Table 18.2), i.e. more than 20 per cent of India's export earnings.

These service exports are a combination of high-tech customised software and low-tech office services, such as cell centers and customer service. Together their impact has been such that India is known as the 'Back office of the world', just as China is now the 'manufacturing centre of the world'.

These services comprise many types of functions such as accounting, ticketing, provision of customised software to provide these services. These functions are together known as Business Process Outsourcing (BPO). India accounts for about 45 per cent of the world's supply of such off-shore services. The major Indian IT companies, TCS, Infosys and Wipro, initiated and perfected the Global Services Delivery (GSD) model. In this used the differences between Indian salaries of software engineers and technicians and, say, US salaries of the same level of software engineers and technicians. The job of, say, providing accounting for a bank, was divided into tasks that were performed onshore, at the site of the client, and off-shore, in India. Using the time difference between the two countries, and the differences in remuneration, the Indian companies were able to deliver high quality IT services to clients, services that were both faster and even better. Their ability to do this depended on the vast pool of Indian software engineers and an even bigger pool of English-knowing staff for functions such as customer service.

The Indian Global Services Delivery (GSD) model has now been copied by many other companies in many countries. Even major IT service providers, such as IBM and Accenture, set up their own IT and call centres in India in order to be able to compete with the Indian companies. With growing competition in the market for providing these services and with rising Indian salaries for the staff, the Indian companies have been forced to move up to higher value-added sections of services. They have moved from BPO to Knowledge Process Outsourcing (KPO), which involves providing services for R&D and to high-end consulting. The Indian IT majors, however, are still striving to establish themselves in the highest end services.

18.5 DIRECTION OF INDIA'S FOREIGN TRADE

With markets in North America, Europe and Japan still stagnant the policy promises a push to increase exports to Central and South America and Africa. In the world as a whole, the economic and trade balance is shifting towards Asia, and what are called the rising powers or BRICS – Brazil, Russia, India, China and South Africa. With rates of growth in these economies, China and India, having been far in excess of those in the developed economies, there has been a process of catching up or closing the gap in per capita income.

China is in the status of an upper-middle income country (per capita income in excess of USD 3,000 per annum), while India is still a lower-middle income country (per capital income of USD1,000 per annum). But the large populations of these countries mean that these economies are very large. Even in absolute terms, China is now the second largest economy in the world after the US, while India is the fifth largest economy in the world, after Japan and Germany. The Asian economies together are now larger than the EU. Thus, the weight of the world economy is shifting with Asia now much more prominent than in the immediate post-colonial period fo the 1950s.

The direction of Indian exports too has been changing, not necessarily in line with the BRICS but away from the traditional markets of the old industrialised countries. As the Table 18.3 shows the roles of the traditional markets (EU, US and Japan) and Asia have virtually reversed over the last 10 years. Whereas the traditional markets accounted for over 58 per cent of India's exports in 2000-01, they account for just about 30 per cent in 2010-11. On the other hand, exports to Asia have gone up from 38.69 per cent in 2000-01 to 54.86 per cent in 2010-11.

What is also interesting to note is that Africa's share of Indian exports has grown from 4 per cent to 6.72 per cent in the same period. As mentioned in another section, Africa is also an area where Indian businesses are seeking to both invest and gain markets.

Table 18.4: Changing destinations of Indian exports.

(per cent Share in India's Total Export)

Region/Country	**2000-01**	**2010-11**
Traditional Markets		
EU	24.00	18.53
US	22.43	10.91
Japan	4.04	2.17
New & Emerging Markets		
Asia & ASEAN	38.69	54.86
Latin America	2.22	4.28
Africa	4.09	6.72
Others	4.53	2.53

India's exports are clearly shifting to the growing economies of Asia and also Africa. As Asia and Africa continue to grow faster than the rest of the world, one can expect the direction of exports to change even further away from the old, developed and now stagnant economies towards the emerging powers of Asia and the rapidly-growing African economies.

Check Your Progress 2

1) State the important changes being observed in composition of India's external trade since 2007-08.

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2) Do you think that direction of India's exports has been changing in time with BRICS Countries?

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3) Give the emerging features of changes in the volume of India's foreign trade.

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18.6 BALANCE OF PAYMENT: CONCEPT AND USES

The principal tool for the analysis of the monetary aspects of international trade is the balance of international payments settlement. This statement, also simply known as the 'balance of payments' (BOP), is a systematic record of all international economic transactions, visible and invisible, of a country during a given period, usually a year. In other words, the statement is a device for recording all the economy transactions within a given period between the residents of a country and the residents of other countries. The BOP of each of the individual countries, technically speaking, always 'balances'. Such equality in the debit and credit sides of the BOP, known as equilibrium, has no economic significance. It simply results from the double entry book-keeping procedure which is used to record the transactions.

The analysis of the BOP can be done in terms of its two major sub-divisions: (a) Current Account, and (b) Capital Account.

Current Account

The Current Account can be broken down into two parts, viz., one, balance of trade, and, two, balance on invisibles. The Balance of Trade (BOT) deals only with exports and imports of merchandise (or visible items). The Balance on Invisibles (BOI) shows net receipts on account of invisibles. These include the remittances, net service payments, etc. It is not necessary that the BOT should always balance; more often than not, it will show either a surplus or a deficit on BOI. If the surplus on BOI equals the deficit on BOT, the current account will show a net balance. But then there is no reason why these two balances should always be equal, again, always in opposite directions. As a matter of fact, the balance on current account can always show a deficit or a surplus. A surplus on current account leads to an acquisition of assets or repayment of debts previously contracted, and a deficit involves withdrawal of previously accumulated assets or is met by borrowings.

Capital Account

The capital Account presents transfers of money and other capital items and changes in the country's foreign assets and liabilities resulting from the transactions recorded in the current account. The deficit on the current account and on account of capital transactions can be financed by external assistance (loans and grants) drawing from the International Monetary Fund and allocation of the Special Drawing Rights.

The BOP accounts provide a link between the increase in gross external debt and the portfolio and spending decisions of the economy.

Thus, increase in gross external debt =

Current account deficit (CAD)

– direct and long-term portfolio capital inflows

\+ official reserve increases

\+ other private capital outflows

The above equation shows that an increase in external debt can have three broad sources: current account deficits not financed by long-term capital inflows, borrowing to finance a reserve build-up or private outflows of capital.

Balance of Payments and Developing Economies

It is well-known in development economics that UDCs invariably start as debtor economies. In the process of development itself, these economies have to import a great deal of capital goods, consumer goods, food and raw materials and spares and components. They also have to import some new technologies and, hence, the total exchange outgo cannot be matched by export earnings. But, it is expected that in a decade or two, as the new capital goods and technologies begin to become effective and their products are directed towards exports, export goods and services become competitive in cost and quality. In that case, the volume of exports expands and, in due course, begins to overtake imports. A developing economy then moves on from being a debtor economy to a balanced one in terms of BOP and, finally becomes a creditor economy, exporting more than it imports and giving credit to buyers. Thus, from being a net debtor in the beginning, it becomes a net creditor in the end and, in fact, begins to invest abroad rather than have others lending to and investing in it.

Current Account Deficit (CAD): Boon or Bane

The general belief is that high CADs are dangerous. In general, this is correct. But the converse – that low CADs are good – is not. As seen above, a CAD is nothing but a measure of a country's saving gap, i.e., the excess of investment over savings. It represents the net transfer of resources from the rest of the world to the country running the deficit. Therefore, in a developing country, with a huge needs for funds for investment, a CAD makes sense. It allows it to finance investments that would have been well beyond what it could hope to finance with its own savings.

On the flip side, CADs are to be financed by foreign capital inflows. The capital flows are fickle can be reversed, and have to be serviced.

The right CAD for any country, therefore, depends on its ability to absorb and service capital inflows. If these resources can be deployed productively and in ways that enhance its ability to repay, a high CAD to GDP ratio is nothing to worry about. But if they cannot, then it is inviting trouble. Too high a ratio can prove unsustainable in the long run as it did in East Asian economies in 1998 and in Mexico earlier. To that extent, low ratio has its advantages.

But, very low ratio carries with it an opportunity cost – of not being able to benefit from resources that could be drawn from outside.

18.7 TREND IN INDIA'S BALANCE OF PAYMENTS

India had faced pressures on BOP from time to time either due to certain domestic compulsions or due to external factors. The whole period, covering nearly six decades, can be divided into two sub-periods, viz. (i) Before 1991, and (ii) since 1991.

i) **Period I (Before 1991)**

The entire period was very difficult for India's BOP, partly because of slow growth of exports in relation to import requirements and partly because of adverse external factors. Foreign exchange reserves were at a low level, generally less than necessary to cover three months' imports. Almost the entire CAD (92 per cent) was financed by inflows of external assistance.

Table 18.5: Key indicators of India's Balance of Payments (As per cent of GDP).

Year Annual Average	Exports	Imports	Net Invisibles	Trade Balance	Current Account Balance
1985-90	5.10	8.30	0.90	–3.20	–2.30
1990-95	7.81	9.51	0.20	–1.70	–1.50
1995-00	8.50	12.04	2.38	–3.54	–1.18
2000-01	9.9	12.6	2.1	–2.7	–0.6
2001-02	9.4	11.8	3.1	–2.4	0.7
2002-03	10.6	12.7	3.4	–2.1	1.3
2003-04	11.1	13.3	4.5	–2.3	2.3
2004-05	11.8	16.5	4.3	–4.7	–0.4
2005-06	12.6	18.8	5.0	–6.2	–1.2
2006-07	13.6	20.1	5.5	–6.5	–1.0
2007-08	13.5	21.0	6.1	–7.4	–1.3
2008-09	15.4	25.1	7.4	–9.7	–2.4
2009-10	13.2	21.7	5.8	–8.6	–2.8
2010-11	14.5	23.2	5.1	–8.8	–3.7

Source: RBI: Annual Report

ii) **After 1991**

The prominent features of the BOP situation as it has emerged over the last two decades can be briefly summarised as follows:

1) On the current account: (i) Trade deficits have been widening. Both exports and imports have multiplied fast, but imports have risen at a faster rate than exports. Expanding imports in turn reflect (a) the impact of liberalisation measures, and (b) increasing manufacturing activity in the domestic economy. (ii) There has been a phenomenal increase in net surplus on account of invisibles. This, in turn, is principally due to (a) buoyancy in private transfers (i.e., inward remittances), and fast expansion in exports of services, especially software. India is unique among emerging economies to have a sizable invisible surplus that substantially offsets the merchandise trade deficit. As a result, although India has been running a current account deficit (except during 2002-04 when India experienced a current account surplus), the deficit has been conveniently manageable, largely because of huge surplus on capital account.

2) On the capital account, India has been running a big surplus. The size of surplus has been much more than what is required to finance the current account deficit. As a result, India has been rapidly building up its foreign exchange reserves. The capital account demonstrates following features: (i) Both inflows and outflows of capital have increased, especially since 2003. (ii) The composition of capital flows is undergoing a change: (a) Official external assistance has been gradually losing out its significance; (b) FDI and portfolio investment have surged, and among the two, the inflows on account of FDI have been more than on account of portfolio investment (except 2010-11 when the trend got reversed). (c) With easing of controls, external commercial borrowings have been coming back into prominence.

Overall, India's balance of payments (current account plus capital account) has been in surplus, resulting in rapid build-up of foreign exchange reserves. This has been due largely to massive inflows of foreign capital. Indeed, the acceleration in India's growth momentum since 2003 owes partly to the exceptionally easy global liquidity conditions that have increased risk-taking and also amplified the volume of capital inflows into India.

18.8 ISSUES RELATED TO BALANCE OF PAYMENT SITUATION

18.8.1 Openness of Indian Economy

As the Table 18.5 shows, the Indian economy has been steadily becoming more open. If we take the trade measures (rows 2 and 3 in the Table.18.6) then the Indian economy is more than twice as open as in 1990-91. Similarly, if we take all foreign receipts and payments, on both current and capital accounts, then its ratio to GDP has gone up from 41.9 per cent in the 1990s to 109.3 per cent now. This means, that the total foreign receipts and payments are now more than India's total GDP. This shows the extent of openness of the Indian economy to foreign payments and receipts. What this also means is that monetary and fiscal policy need to be undertaken very carefully, taking account of possible international effects. As the current problems of Greece and other EU economies shows, no country can now be unmindful of the international consequences of its fiscal deficits. The lesson is not that there cannot be fiscal deficits, but that international consequences need to be kept in mind. Does this make the Indian economy much more vulnerable to the transmission of external shocks, shocks emerging from other parts of the global economy? A brief look at the different impacts of India's own crisis in 1991, the Asian crisis of the late 1990s and the ongoing (2007 onwards) global financial crisis will show the differences in impacts, and also the manner in which the Indian economy has been able to withstand these shocks.

Table 18.6: Different measures of openness of the Indian Economy.

1)	Openness Indicators (per cent)	Avg. 1990-91 to 1999-2000	Avg. 2003-04 to 2007-08	2010-11
2)	Exports plus Imports / GDP	18.8	30.4	36.5
3)	Exports plus Imports of Goods and Services / GDP	22.9	40.8	49.0
4)	Current Receipts and Payments plus Capital Receipts and Payments / GDP	41.9	83.5	109.3

Source: RBI, 2011, Annual Report 2010-11, Appendix Table 1, p. 170.

Does this make the Indian economy much more vulnerable to the transmission of external shocks, shocks emerging from other parts of the global economy? A brief look at the different impacts of India's own crisis in 1991, the Asian crisis of the late 1990s and the ongoing (2007 onwards) global financial crisis will show the differences in impacts, and also the manner in which the Indian economy has been able to withstand these shocks.

18.8.2 External Debt

The Indian economy in 1991 was relatively closed, much more so than in the late 1990s or now. Nevertheless, it experienced a severe shock, one which forced a drastic change in trade and even development policy. What was the shock of 1991? India had a negative trade balance, with imports much more than exports. Foreign exchange balances at that time were just below $5 billion, enough to cover just two weeks of imports. At the same time, India had built up large external debts. In order to secure a roll-over of these debt payments, India had to pledge its gold reserves, physically air-lifting some of it to London. It also secured a loan from the IMF to tide over the immediate crisis.

How did this external crisis come about? The Indian economy in 1991 was not as open as it is now, yet it faced an external crisis. To understand this crisis, one must turn to the relation between the fiscal deficit and the external deficit. India had a high fiscal deficit, more than 7 per cent of GDP. Its interest rates were high. In national accounting terms an excess of spending over income gets reflected in a balance of payments deficit. This deficit could be covered by foreign investment or debt. But at some point the foreign debt has to be repaid. In the late 1980s a substantial portion of external debt was of the short-term variety.

Further, the high government spending behind the fiscal deficit was not used to fund investment — had that been so, and had that resulted in a substantially higher rate of growth, then the economy would have grown and made it possible to service the debt. But the fiscal deficit did not result in greater investment, rather it was used in what is called non-plan (non-investment) expenditure. With that the ratio of debt service to GDP went up and became a multiple of available foreign exchange (see table below). The result was that in 1991 India had reserves that were just sufficient to cover one week's imports. The crisis was averted by borrowing from the IMF and then undertaking reforms of both external and domestic sectors of the economy.

Table 18.7: Key external debt indicators, 1990-91 to 2009-10.

As in end-March	Total debt $bn	Debt/ GDP (per cent)	Debt/ Current receipts ratio	DSR 9 per cent)	Short-term debt/ total debt (per cent)	Short-term debt/foreign exchange reserves (pre cent)
1990-91	83.8	26.4	323.0	34.6	10.2	146.5
2000-01	101.3	22.0	130.4	16.5	3.6	8.6
2009-10	261.2	19.9	76.1	5.5	20.0	18.8

Source: The New Oxford Companion to Economics, Vol. 1, p. 203.

The experience of 1991 should not lead to the conclusion that foreign debt must be avoided at all costs. Rather, foreign borrowing is important to increase the volume of funds available for investment in a developing economy. It allows the economy to investment beyond its own savings. But it is also necessary that the borrowed money be used for investment (other than in a situation of a dire emergency, as in a serious drought) so that economy grows and is able to repay the debt. Alongwith growth, there is a need for foreign earnings too to increase so that the debt can be repaid.

If we look at the last row of Table 18.6, pertaining to 2009-10, it will be seen that India's debt is now more than the level it was at in 1990-91. But since the

Indian economy has been growing at more than 6 per cent per annum in the 1990s and at more than 7 per cent per annum in the 2000s, the debt to GDP per centage has come down from 26.4 per cent in 1990-91 to 19.9 per cent in 2009-10. What is important the debt service ratio (DSR – which is interest and principal repayments as a proportion of exports) has also come down from 34.6 per cent in 1990-91 to just 5.5 per cent in 2009-10.

The only worrying aspect of the debt situation is the increase in the proportion of short-term to total debt from 10.2 per cent in 1990-91 to 20.0 per cent in 2009-10. This increase in the proportion of short-term debt is due to external borrowings by Indian businesses. While the increase in short-term debt is not of a magnitude to affect the macro situation of the economy, borrowing firms could be affected by exchange rate fluctuations. For instance, in later 2011 the Indian rupee fell to a low of Rs. 59 to the US$. Those companies that had borrowed at, say, Rs.45 to the US$ a year ago, would have fond their liabilities suddenly increase. Of course, they could have protected themselves by hedging their borrowings.

Since 1991 India has built up substantial foreign exchange reserves, now in excess of $350 billion. This is the fifth largest foreign exchange reserve in the world, but it is very small in comparison to China's $2 trillion foreign exchange reserve. The Asian economies, in particular, have been accumulating foreign exchange reserves after the late 1990s Asian financial crisis. In that crisis many Asian countries had to approach the IMF for emergency loans. A flawed policy followed by the IMF forced these countries to reduce government expenditures and have balanced budgets. This resulted in a further contraction of the South-east and East Asian economies, already hit by the Asian crisis.

After this experience of having to borrow and being forced to follow a policy of contraction that negatively affected their economies, the Asian countries seem to have drawn the lesson that it was important to build sufficient foreign exchanges for any future crisis. India too has followed this policy. In a way, this is a policy of self-insurance, which is not the best way to have insurance. But in an uncertain world where power pressures are at play, countries do decide to build their own defenses against risks of downturns. Building up reserves comes at the cost of growth, as the reserves could be invested to speed up growth. But there is a trade off between growth and risk and countries seem to have decided to reduce some growth in order to build their capacity to withstand shocks.

One of the factors that has helped India build reserves is remittances. Large number of Indians work abroad. This includes not only the high-profile Indian professionals, but also the millions of Indian workers in West Asia and elsewhere. Remittances from migrants were as much as $54 billion in 2009-10, and that amounted to 3.9 per cent of India's GDP. These remittances have financed a large portion of India's balance of trade deficit. Remittances are the most important source of external finance, more than foreign investments or loans from foreign governments.

18.8.3 External Shocks

With growing openness of the Indian economy it becomes more susceptible to external shocks. But how open is the Indian economy? There are two measures one can use of openness. One is to take the ratio of exports and imports of goods and services to GDP. This has been rising from about 30.8 per cent in 2002-03 to 46.4 per cent in 2007-08 and now more than 60 per cent in 2009-10.

The above measure only deals with trade. But there are also financial inflows on both current and capital accounts. Taking that into account we get a measure of openness [current receipts and gross capital inflows] + [current payments and gross capital flows] as a ratio of GDP. By this measure openness rose from 49 per cent during 1997-98 to 1991-2 to an average of 80 per cent from 2002-03 to 2007-08. The ratio of gross inflows and outflows to GDP was as high as 120 per cent in 2007-08.[1]

This second measure better expresses the degree of connections between India and the rest of the world. A country is affected not only by trade flows but also by overall financial flows, on both current and capital accounts.

In a completely open economy capital and flow in and out at will. When returns are high compared to other countries, there could be a large inflow. This itself could be destabilising in that there would be an increase in money supply, with the possibility of inflation. On the other side, when returns fall below those in other countries, then there could be a massive outflow of capital, again negatively impacting the economy.

India has not followed such a policy of open capital markets. There are controls on both inflows and outflows. This control on capital account used to be criticised in many quarters. But after India better managed the shock from the global economic crisis of 2008-10, there has been appreciation of India's policy of only gradually opening the capital sector. Along with this control on capital flows, India's banking sector too was restrained. It was restricted in the extent to which it could move into non-bank financial sector, such as insurance. Thus, the Indian banking system, unlike those in the developed countries, were not so exposed to the collapse of non-bank sectors such as insurance. Their exposure to banking assets in other countries were also limited.

While monetary policies and banking guidelines played a major role in not allowing the financial collapse in the developed countries to spread to India, there was an impact on India's exports of the contraction of developed country markets. In addition, uncertainty in the economic scene led Indian businesses too to postpone investment, even in sectors such as construction, which had nothing to do with the external market. Overall investment fell by about four to five per centage points.

Export contraction and business uncertainty together led to a fall in employment in sectors such as diamond cutting and construction. Here the Government of India followed the standard Keynesian prescription of increasing the size of the budget deficit to make up for the shortfall in private investment. Measures like the MGNREGS, the rural employment guarantee scheme, which were already in place, were automatically increased in size to provide employment to the urban unemployed who returned to rural homes.

Following the ongoing global slowdown, there has been a slow-down in the rate of growth of Indian exports. Markets in the industrialised countries have contracted or remained stagnant. The government announced a 'New Export- Import Policy for 2009-14'. There are the expected measures of certain support, in the form of drawbacks, easier import of capital goods, diversification of exports into new products. More important are the measures to reduce transaction costs through reductions in procedures.

[1] This is based on Y. V. Reddy, the former Governor of the Reserve Bank of India, in his book *India and the Global Financial Crisis: Managing Money and Finance*, Hyderabad: Orient Blackswan.

What is new in the new trade policy is the emphasis on seeking markets outside the major industrial powers of the North Atlantic, Europe and Japan. The policy promises support to expand exports to South America and to Africa too.

An important problem in increasing exports is the constraint of poor infrastructure. It is estimated that Indian logistics costs are about 13 per cent of cost, as against the international norm of 8 per cent. Reducing the infrastructure deficit is key to increasing exports. Another factor, often debated, is that of supposedly restrictive labour laws. The requirement of government permission to retrench or lay-off workers in an enterprise that has more than 100 workers is cited as a key problem in enabling owners to cross the 100 worker-size of enterprise. Consequently, there is a strong tendency for Indian firms to either remain below 100 workers in size or be very big. There is a problem of what is known as the 'missing middle' in Indian manufacturing.

At the present juncture there is a big opportunity for India to increase its exports of labour-intensive products, such as garments and leather products. Wages are going up in China and as a result Chinese exporters are having to move up the value chain, to more technology-intensive exports. This provides an opportunity for lower-wage countries, such as India, to move into these labour-intensive sectors. Will that, however, require improvements in infrastructure and flexibility in hiring labour?

Check Your Progress 3

1) What do you mean by current accounts deficit in balance of payments?

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2) Why did India face the adverse balance of payment prior to 1991?

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3) What do you understand by the term openness of Indian economy?

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4) How can you measure the openness of Indian Economy?

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18.9 LET US SUM UP

Under outward-oriented growth strategy, foreign trade is considered as engine of growth. It contributes to economic development in a number of ways. The foreign trade of any country can be analysed in terms of volume, composition and direction. Taking goods and services together the ratio of exports and its importance to India's GDP has gone up from 23 per cent in 1990s to 49 per cent in 2010-11 marking trade as a growing feature of Indian economy. However large current account deficit in goods trade is a matter of concern. The composition of India's external trade has been changing from primary goods to manufacturing and engineering goods. Similarly direction of India's exports is shifting from away from the traditional markets (EU, USA and Japan) to Asia. India's balance of payment has been in surplus resulting in rapid build-up of foreign exchange reserves largely due to massive inflows of foreign capital. Indian economy has been steadily becoming more open and hence international consequences need to be kept in mind by the policy makers.

18.11 SOME USEFUL BOOKS

Basu, Kaushik and Annemie Maertens, (ed.), (2011): *The New Oxford Companion to Economics in India*, Oxford University Press, New Delhi

Bhagwati, Jagdish, (2004): *In Defence of Globalisation*, Oxford University Press, New Delhi

RBI, Annual Reports.

Ministry of Finance, Economic Survey, 2010-11.

NASSCOM, Annual Reports.

Reddy, Y.V.: *India and the Global Financial Crisis: Managing Money and Finance,* Orient Blackswan, Hyderabad.

18.12 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) See Section 18.2

2) See Sub-section 18.2.1

3) See Sub-section 18.2.3

Check Your Progress 2

1) See Section 18.4

2) See Section 18.5

3) See Section 18.3

Check Your Progress 3

1) See Section 18.6
2) See Sub-section 18.7
3) See Sub-section 18.8.1
4) See Sub-section 18.8.3