CHAPTER 1
INTRODUCTION

1.0. The Setting

Understanding the nature and problems relating to India's external trade and payments position is a complex task and warrants an in depth inquiry into the inter-linkages between various sectors and the related issues. These have structural and institutional dimensions that have been existing ever since independence. Problems such as trade balance (TB) and balance of payments (BOP) deficits, foreign exchange shortages, deficit financing, rising inflation etc., though appear to have been solved during some specific short periods, have continued unabated and frustrating policy formulations.

The BOP crisis has intensified after the mid sixties primarily due to the widening of trade gap, successive droughts, oil shocks, mounting external debt, and the growing budget deficit. When the situation went out of control, the government resorted to devaluation as a last resort to overcome the crisis as a short-term measure.

During the process of planned development with inward oriented industrial policies, resulted in high cost structure and economy continued to depend on strategic imports to implement its plans. The share of India's exports in world trade fell from
1.91% in 1950 to about 0.53% in 1992. The trade deficit continued to widen except for one year during 1970's. The second oil shock of 1979 was more severe as compared to the first one of 1973-74. There was a substantial increase in petroleum, oil, and lubricants (POL) imports and the world recession of 1980-83 depressed the export performance. However, an increase in domestic production of crude oil during 1984-85 has eased the balance of payments position to some extent.

During the second half of 1980s, the current account deficit continued in spite of a robust growth in exports. The non-oil imports, export related imports rose significantly. The deterioration in fiscal imbalances—ratio of gross fiscal deficit to GDP; rose from 6.3% in the first-half of the 1980's to 8.2% during 1985-90. The debt service ratio rose to 30.9% in 1989-90. The Gulf Crisis of 1990 resulted in a decline of Non-Resident workers' remittances and an increase in oil import bill. This has lead to the recent devaluation in July, 1991. The present study tries to analyse the whole gamut of issues underlying the above policy measure viz, devaluation in its entirety.

1.1. INDIA'S FOREIGN TRADE POLICIES - A REVIEW

A brief review of India's foreign trade policies is presented here. International trade is an activity of strategic importance in the development process mainly of a developing economy. Scarce foreign exchange resources provide crucial inputs
and capital goods that are needed in the early stages of economic development. In view of the several limitations to the inflow of foreign aid, foreign trade assumes greater significance in the earnings and conserves foreign exchange resources. The choice of suitable economic policies—import substitution, or export promotion and related trade and industrial policies constitute significant part in the overall framework of the economic policy.

India has inherited a system of quantitative restrictions since the Second World War. During the first five-year plan, with good harvest and little pressure on the foreign exchange, the system continued without any major modifications. However, with the second plan onwards, there was a massive rise in the developmental expenditure and expansion of investments. As the developmental projects depended heavily on import of capital goods and machinery, soon it resulted in a shortage of foreign exchange which got compounded in later years with large imports of food grains and petroleum products. It was at this time that two basic policies viz (a) Industrial targeting and licensing and (b) Exchange control were introduced which were aimed at improving the economic efficiency of the regime.

During the second and third five-year plans (1955-66), import licensing and the exchange control policies were aimed at a comprehensive and direct control over the foreign exchange utilization. The major criteria for the use of import license
relate to the essentiality of imports and the indigenous non-availability of the imported products. The restrictions in the form of high import tariffs resulted in high import costs and led to a stagnation of import intensive exports.

There was an attempt for partial liberalization from 1962 onwards with export subsidies given in the form of fiscal measures or import entitlement schemes. On 6th of June, 1966, the rupee was devalued by 57.5% and it stood at Rs. 7.50 per dollar compared to Rs 4.75 earlier. This devaluation was the culmination of liberalization trend that had begun in the third plan and there was a considerable attempt to rationalize the trade and payments regime. The details of this 1966 devaluation package and its after effects are well documented in Kruger and Bhagavati (1974).

The petroleum price hike (first oil shock of 1973) resulted in acute foreign exchange shortage initially but soon was resolved with the increase in remittances from expatriates working in the Gulf countries.

However, the country's increase in imports led to the worsening of trade balance. When the Bretton Woods international monetary system collapsed in 1973, Indian Rupee was delinked from the Pound Sterling and has been linked to a basket of currencies. The exchange rate system had changed from the fixed exchange rate system to that of managed/flexible system with the
Reserve Bank monitoring the exchange rates.

The proliferation of export incentives during the 1970-80 and the widening trade gap prompted the setting-up of committees to review the trade and industrial policy regimes. The need to reduce the trade gap and to bring about stability in the trade policies was recognized. Accordingly, a three-year trade policy called as Import-Export policy of 1985-88 was introduced to reflect the liberalization trend with a considerable relaxation of import controls and a reduction of import duties on capital goods. The tariff structure was simplified by reducing the previous eleven auxiliary customs duty rates to only three rates. They are fixed at nil, 25% and 40%. Further, computerization of the custom houses was a major move to reduce the administrative delays. The trade policy reinforced the policy of canalizing agencies.

The Import-Export Policy of 1988-91 also strengthened the process of trade liberalization. Seven hundred and forty three new items have been brought under Open General License (OGL). The benefit of import replenishment has also been enlarged based on the net value added in the export products. Twenty six items of exports have been decanalised and the procedure of licensing was abolished for them.

The year 1990-91 was marked by a severe balance of payment crisis due to unfavorable developments in the external sector. A
steep fall in the growth of exports may be attributed to a variety of reasons both internal and external. External factors included recession in the US and the UK, changing international economic environment, the Gulf crisis and decelerated rate of growth of exports to rupee payment countries. The internal factors included the erosion in the competitiveness of exports, rising inflation, high import elasticity of exports, and slow rate of depreciation in nominal exchange rate resulting in the contraction of exports.

The Gulf crisis had resulted in an adverse situation on the merchandise trade. It affected both ways, namely, in an increase in POL import bill and contraction in exports (due to a trade embargo on Iraq). The rise in crude oil price emanating from the Gulf crisis had resulted in a massive bulge in import bill. Consequently, the growth of exports achieved during 1985-86 to 89-90 could not be sustained in 1990-91 due to the above mentioned reasons. The payments crisis coupled with the pressure on internal price front necessitated the formulation and implementation of a package of reforms in fiscal, industrial and trade areas.

Government announced a new trade policy on 4th of July, 1991 to carry out major structural reforms in the area of external trade. This followed the downward adjustment in the value of the rupee affected on the 1st and 3rd of July, 1991. Various other measures with regard to foreign exchange remittances, repurchase from the IMF, structural adjustment loan from the World Bank,
aid from the Aid-India Consortium and an upper credit Tranche stand-by arrangement from IMF were also undertaken to improve India's balance of payments.¹

However, the economic performance in 1991-92 looked to be a mixed one. Severe inflationary pressure was built-up in the economy and industrial production suffered a setback due to import compression measures.

Along with the exchange rate adjustment in July 1991, EXIM scrip scheme was introduced. This policy measure tried to establish a quantitative link between imports and exports, under which certain imports were permitted only against export entitlement. This was followed by a dual exchange rate arrangement, which is known as Liberalized Exchange Rate Management System (LERMS). According to this scheme, 40% of exchange earnings are to be surrendered at official exchange rate, and the rest can be exchanged at the market exchange rate. This system brought about stability in the exchange rate and the spread between official and market rates moved in a relatively narrow range of around 17%. Since 1st of March 1993, almost all foreign exchange transactions began to be put through at the market determined exchange rate.

¹See Rangarajan (1994)
The above review of India's trade policies can be summarized as follows: In the early years of planning process import substitution trade policies were adopted and these resulted in high cost structure and foreign exchange shortages. The need to give importance to exports was felt and consequently, incentives were given to promote exports. However, after the 1966 devaluation package, though the trade and payments regime was liberalized to some extent, the trade policies had continued to be of ad hoc in nature, and it was only from 1985 onwards, a three-year trade policy was introduced to induce stability for a period of time in the policies. The slow growth of exports, the continued liberalization of imports and other external factors caused a deep crisis in 1990-91 forcing the country to devalue its currency.

The above review highlighted the fact that though the trade policies changed according to the need of time, long-term measures to sustain the growth in exports and to minimize the imports were not given enough importance. Whenever the foreign exchange shortage occurred, import compression measures along with export promotion incentives were undertaken. When once the shortage was temporarily tackled, there was rise in imports again due to liberalization efforts. The exports could not be sustained because of the structural rigidities, high cost structure and lack of quality competitiveness of our exports. Therefore, there
is a need to frame policies which can be sustained for a longer time and able to address the fundamental causes of the trade deficit and BOP crisis.

1.2. FOCUS AND OBJECTIVES OF THIS STUDY

The present study focuses its attention on the long-standing problems of India's trade deficit, declining foreign exchange reserves and spiralling domestic prices. It tries to identify the determinants of India's trade balance and inflation within the framework of a Computable General Equilibrium (CGE) model. It examines the policy impact of exchange rate changes (devaluation) on important macro-economic aggregates of the economy. The need for a proper integration of monetary and trade sectors in analyzing the effects of devaluation is emphasized. The model takes into account some of the institutional features of the Indian economy such as foreign exchange rationing, export subsidies, import restrictions, etc.

The following are the specific objectives of the present study:

(i) To examine critically the devaluation concept, the major approaches using this concept and the linkages between trade and monetary sectors,

(ii) To review the existing models linking devaluation, trade balance and inflation using monetary approach with a view to identify a suitable methodology and model for analysing the current BOP crisis,
(iii) To identify the determinants of demand for real cash balances, export supply, import demand and India's trade balance,
(iv) To analyze the effect of devaluation on trade balance, BOP and inflation in a theoretically consistent CGE framework,
(v) To examine the usefulness of devaluation as a policy instrument to improve trade balance and BOP, and
(vi) To undertake policy analysis involving hypothetical policy changes like devaluation, credit control, reduction in subsidies, import tariffs, and increase in export demand elasticity.

1.3. JUSTIFICATION OF THE STUDY

Earlier studies made use of models in which devaluation as an instrument to study problems relating to Trade Balance (TB) and Balance of Payments (BOP) and focussed on how devaluation affects output, prices, TB, money supply and other related macro-economic variables. They can be grouped into three broad categories viz. elasticities, absorption and monetary approaches. These approaches made certain theoretical and empirical propositions which were tested while analysing the effects of devaluation on TB and BOP using both multi-country as well as country-specific data. Improvement in the availability of reliable data and the econometric techniques prompted the growth of literature in this area. Both macro-econometric and
computable general equilibrium models were used in these studies.

The LDCs having similar BOP problems started adopting these models straightaway. Though it may sound too strong a proposition, yet, the fact remains that these approaches were developed in the advanced industrial countries to suit their economies. These models are unable to explain the behavior of LDCs' BOP crises mainly because these economies have an altogether different institutional background and also because the principles that guided the trade pattern of advanced countries cannot directly be applied to these LDC economies. The three approaches were also tested using Indian data and it was found that none of them in isolation was capable enough to explain the nature and behavior of our external sector. Due to the non-availability of an ideal model for the Indian economy, as a justification, one can adopt a closely related model and modify it to suit the economy. To analyse the BOP crisis in India, one needs to consider India's structural rigidities, development priorities and the conflicting objectives in our Five Year plans. Further, the non-synchronization of industrial and trade policies with built-in adhocism calls for a pragmatic and careful approach in analysing the BOP crisis situation.

With the above objective, we examine in some detail the devaluation concept and the related issues. Then, a critical review of the existing works is undertaken to identify the gaps
and choose a suitable methodology for the present study.

1.4. DATA SOURCES AND ORGANIZATION OF THE THESIS

The data required were collected from various issues of the following sources:

(i) Report on Currency and Finance
(ii) International Financial Statistics
(Hi) National Account Statistics
(iv) Reserve Bank of India Bulletins

The dissertation is organized in the following manner: Chapter 1 contains a review of the trade policies in the Indian context, Chapter 2 discusses the devaluation concept, theoretical approaches to devaluation and trade and monetary sector linkages. Chapter 3 reviews the empirical studies on devaluation, trade balance and inflation. Chapter 4 presents the methodology of this present study. Chapter 5 contains the empirical results and Chapter 6 consists of policy analysis and conclusions, chapter 7 gives summary, conclusions and limitations of the study.