CHAPTER: 1

INTRODUCTION

Mutual enrichment is the basis of regional cooperation and foundation of International trade between nations. International trade refers to trade that carve out between two or more countries of the world. All countries of the world participate in international trade. Trade gives consumers and countries an opportunity to be exposed to those goods and services which are not available in their own country. Therefore, countries import those goods and services from abroad in which they are less efficient to produce or cannot produce at all. Similarly, they export those goods and services for which they are more competitive in, owing to their geographical conditions and expertise of their labour force. There is no country in today’s world which does not participate in international trade, as one cannot afford to live in autarky.

During last few decade’s trade links between countries has been increasing and some important factors which helped in mounting international trade overtime are low tariffs, low transportation costs and lower communication costs. After world war second world trade has grown and multilateral and bilateral trade liberalization plays a key role to increase world’s trade. World’s Gross exports are almost three times more than what was prevailing in the 1950s. The important trends which helped in the expansion of global trade were - the rise of Emerging Market Economies (EMEs), the growing importance of regional trade and shift of higher technology exports towards dynamic EMEs. Over time the diversification in the major partners of global trade was accounted together for the United States, Germany and Japan. But in 1990 there are several EMEs in East Asia, especially China, which becomes the second largest trading partner after the United States.¹

Another noteworthy feature of modern trade is the internationalization of production. There is a change in the nature of trade, now countries are specialized in producing a particular stage of a good instead of producing a complete good in one country. Instead of concentrating production in a single country, the modern multinational firm uses production plants-operated as subsidiaries in several countries. By operating as subsidiary firms can exploit the advantages of location,
such as proximity to markets and access to relatively inexpensive labour. This vertical trade is also what links heightened international trade to greater international production.

There is a considerable change in the composition of world trade, which is mostly based on the introduction of new technology such as computer and other hi-tech electronic goods. The most significant change in international trade is the growth of the services sector. The growth of services trade increases even much faster than the merchandise trade. Trade in commercial services changes continuously in a positive direction and there is a change in the structure of world trade. Between 1980 and 1994 the share of agricultural products declined from 14.7 percent to 11.9 percent, share of mining products from 27.7 percent to 10.7 percent and the share increase in manufacturing from 53.9 percent to 74.3 percent. These figures point to a clear ascendancy of manufacturing trade and decline in mining products.

International trade institutions also help to enhance trade between countries. Institutions like the World Trade Organization, North American Free Trade Area, South Asian Association for Regional Cooperation and European Economic Community and many others help to resolve the conflict between their member countries and try to increase the trade between member countries. International Trade Organization makes sure that trades between countries goes smoothly and freely. These institutions help to make trade rules and to make trade agreements and also helps countries to settle their trade disputes. International institutes contribute to the economic activity of the poorest countries of the world and watch out that the benefit of the trade also reaped by poor countries.

International trade is termed as an engine of economic growth and it is very true for developing countries because it helps in many ways which can contribute to economic growth. It helps in expanding the size of the market and makes possible the division of labour and economies of scale which is important for the production of light manufacturers and it helps small developing economies like Taiwan, Hong Kong, and Singapore to grow. China is one of the leading economies of the world and it is the best example to show that international trade helps in the development of an economy.
India is a member of many international institutions which helps it to enhance its
growth and trade like - International Monetary Fund, Asian Development Bank,
World Bank. India is facing the problem in disequilibrium in the international
balance of payment and international institution like the International Monetary
Fund provides financial assistance to India, which helps India to decrease the level
of disequilibrium in the balance of payment and also make easy the development
and balanced growth of international trade. India is also a member of the World
Bank, which assisting India in its planned economic development by granting
loans, conducting field surveys, rendering expert advice, sending study teams and
training Indian personnel for economic development of India. India has also joined
many international organizations which help to increase its trade with other
countries like world trade organization, South Asian Association for Regional
Cooperation, European Economic Community.

South Asian Association for Regional Cooperation was established in 1985 with
the aim to accelerate the process of economic and social development in South
Asian countries. To accelerate the trade in South Asian countries SAARC did
reduction in qualitative controls, which include the tariff and non-tariff barriers
on imports and the grant of commissions. Being a member of SAARC India gets
help to increase its trade with South Asian countries. World trade organisation
helps India to increase its trade with member countries by lowering the tariff rates
and settling the disputes between the member countries.

India has always been an active participant in international trade, particularly after
independence, but during these sixty years there are tremendous changes had been
made in the foreign trade of India.

1.1. INDIAN ECONOMY DURING PRE LIBERALIZATION PERIOD

During the period of pre-liberalization, industrial structure of the Indian economy
was weak both financially and technologically. The major reasons that the
investments have not attracted towards the Indian economy were inefficiencies,
high costs for producing goods, poor management, non-competitiveness, excessive
reservation, import controls, lack of export orientation and incentives are not given
to foreign investors. Prior to 1991, there was higher degree of control over
industrial activity because development strategy discouraged import from abroad,
which was necessary for industrial output. Limited domestic resources spread by licensing of manufacturing activity. Industrial policy has dominated by licensing constraints by virtue of which strict entry barriers were maintained.\(^5\)

Period of pre liberalization was divided into two periods one from 1950 to 1970 and another is from 1970 till liberalization and the policies during these periods was trending towards tighter controls and growth rate during this period is not above 4 percent.

**1.1.1. INDIAN ECONOMY DURING 1950-1970**

During the first few decades after independence, there was a modest growth rate of 3.6 percent. During the first plan after independence, policies which were made were intended towards progressive liberalization. Tariff rates have been stepped-up for thirty-two items in 1954 which provide the way for liberalization of import quotas and also provide additional licenses. In 1957 foreign exchange crisis and the policy adopted in second year plan of heavy industrialization force government to adopt the policy of import substitution. This strategy proves successful in raising the level of resource mobilization and investment in the economy, but at the huge cost in terms of economic efficiency.

Strain on BOP is another reason which leads to the high tightening of import policy in 1957 and many policies were implemented especially during 1957. Instead of Open General License, limited quotas were granted to importers on the basis of their actual import during 1952-56. Under the new policy fresh licenses were not issued, imports of consumer goods being cut drastically and imports of raw material and intermediate goods being limited to the minimum which are necessary for the maintenance of production. Special licenses for import of raw material were granted on the basis of export performance. Capital goods licensing continued to be confined to the highest priority programme. Import substitution policy no doubt influenced by theories like prebisch singer hypothesis that production declining Terms of Trade of good for less developed countries. Under the regime that evolved, the producers needed to make only minimal effort to get absolute protection against imports. The authorities applied the principle of indigenous availability, according to which the government denied the allocation of foreign exchange for importing a product if substitutes for that product was
available in the domestic market in sufficient quantity. There are few short
comings in this principle which include that if producers wanted to block the entry
of imports of a product they only has to do, is to let the relevant agency know that
he can produce a substitute for import, but there are few factors which were
ignored while adopting the principle of indigenous availability is that the quality
of the substitute, the price at which it was supplied, and any delay in delivery were
of secondary importance to the authorities.

In 1960s India undertook few steps toward liberalization of import licensing,
tariffs, and export subsidies. The legalization measures gave freedom to import
their raw material and this legalization was given to only fifty-nine industries,
covering 80 percent of output in the formal which is also known as organized
sector, freedom to import their raw materials and components but the policy of
obtaining license for industries remains. These changes in policies lead to a sharp
increase in imports whether it is government or private import and especially there
is an increase in import of food grains, raw cotton and metals import. During this
period, to maintain BOP, attempts had also been made to increase export. Schemes
were made and implemented to promote export such as, Government set up 12
Export Promotion Councils in respective areas. Instead of every attempt which has
been made by government to avoid the strain on balance of payments it once again
came under considerable pressure in 1964-65 due to rising debt service burden,
repayment to the IMF, increase in imports of food and goods for development. The
exports were not sufficient to meet the import requirements and India face
financial crisis in mid of the 1960’s which lead to devaluation of rupee from 4.7
rupees to 7.5 rupees to the dollar and the second reason of devaluation was the
drought of 1965-66 which causes the price rise over 10 percent.

1.1.2. INDIAN ECONOMY DURING 1971-1991

1970 and early 1980’s witnessed the complex system of licensing. Tariffs were
given more preferences than quotas. License for imports were given only if firms
satisfied the government agencies that it was essential for further production as
input or equipments and license were permitted for the import of those goods
which were not produced in the country if it showed that there was domestic
production of those goods than permission of license was not permitted.
The restricted import policy start showing its effect because this import control which stiffened the manufacturing sector and modernization of technology in the industrial sector is important for its growth, which in turn affects the economic growth of a country and these backdrops of import restriction called for economic reforms and thereafter India slowly started shifting towards export led growth because import substitution strategy did not yield the desired results. There are two factors which cemented the way for liberalization in the late 1970s. First, industrialists began to lobby for the imports of raw material and machinery for which there is no domestic production and this restriction became a reason for less profitability of industrialists. Policy makers get evidence from the export performance and allowance from overseas workers which is improved over the time in the Middle East led to the growth of a healthy foreign exchange reserve and this evidence give confidence to policy makers that liberalization policy also have a positive effect on the balance of payments. In 1976 there was the reintroduction of the open general licensing list, which leads a new phase for liberalization. It has been introduced in the early years after independence, but stress on the Indian economy in 1966 which leads to even devaluation of currency cause the control on OGL list. After 1976 licenses were required from the ministry of commerce even though the item was present on the OGL list. Items on OGL list cannot be imported freely and in case of machinery imports importers have to take clearance from the authority, which is providing industrial licenses. Commodities under Open General License category have a liberal system of licensing. Import of capital goods was divided into two categories one was restricted category and another was OGL category. Capital goods which were under the OGL could be imported without a license while intermediate goods falling into a banned category and which come under OGL category were governed under conditions. The import of consumer goods was also banned.

In 1970, Government of India announced new industrial licensing g policy and according to this policy larger industrial houses and foreign enterprises were allowed to set up industry in the core and heavy investment sectors except industries reserved for the public sector. Government policy of foreign investment of 1972-73 attracted the foreign capital in the form of branches, non-resident Indians investment and employment of foreigners in India. In October 1980
Government revised the foreign investment policy in this policy and emphasis was given to tap the resources from oil exporting developing countries. In 1982-83, Government liberalized facilities in the financial sector, which includes bank deposits, investment in equity shares of the corporate sector, preference share and debentures issued by an Indian company. To facilitate investment, Reserve Bank of India simplifies formalities related to exchange control procedure. In 1983-84, Government provided the incentives in the form of (1) Taxation of investment income derived by a non resident Indian from the specified investment and long term capital gains arising out of the transfer of these assets at a flat rate of 20 percent plus surcharge of 12.5 percent of such income tax. (2) Exemption on long term capital gains arising from transfer of any foreign exchange asset, (3) Exemption from wealth tax on the value of foreign exchange assets acquired and held by non resident (4) no tax has to be paid by non-residents Indians on gifts which they were sent to their relatives in India by the incentive of exemption from gift tax. In 1982-83 items given large concession that are present on OGL list and tariff rates were raised substantially. In 1985, new policies were made in which they partly neutralized the antitrade bias of import controls. This measure had a trade-liberalizing dimension as well, since it freed machinery imports in these sectors from industrial licensing clearance. Import flows were also helped by improving agricultural performance and by the discovery of oil, which made room for nonoil, non-food imports, mainly machinery and intermediate inputs. During 1985-90, nonoil imports grew at an annual rate of 12.3 percent.

As a result of new policy of liberalized import licensing, the import of capital goods increase from 11 percent to 18 percent. The number of capital goods in open general licensing (OGL) has increased from 79 in 1976 to 1170 in 1988. In case of intermediate goods all items are steadily shifted from restricted and permitted category to OGL category, in 1988, 949 intermediate inputs were included under this category. Further restrictions were relaxed even more to encourage technological modernization, which helps in the modernization of Indian Industry. These new policies which are adopted in the decade of 1980 increase the annual growth, especially during 1988-91, when it reached 7.6 percent. But the fiscal expansion, which is based on the external and internal borrowing was unsustainable and in 1991 leads to a balance-of- payments crisis in June 1991.
This time, however, the government turned the crisis into an opportunity: and this time government adopted the policy of liberalization and do not reverse the policy as it is done before in 1957, government launched a beyond doubt wide-ranging, organized, reform program that continues to be put into practice today.

1.2 INDIAN ECONOMY: POST LIBERALIZATION ERA

In July 1991 India opened up its economy and made a clear switch in favour of outward-oriented, market-based economy. Decision which was made to go for market based economy was opted because of many experiences like the phenomenal economic rise of China after its adoption of outward-oriented policies and India’s own experience with protectionist policies for three decades and then with liberalization in the 1980s, finally persuaded policymakers of the merits of the policy approach towards pro-market and pro-free trade economists.

India entered into the process of expansion of its trade in the world after the crisis of 1991 and after 1991 the government started a series of economic reforms and opens its economy more liberally to the external world. Indian government adopted the policy of Liberalization, privatization and globalization, which resulted in fast growth of its foreign trade. It implemented reforms to almost every sector of the economy. In the external sector following reforms had been made - reduction in import licensing and peak custom duties, amendment in FERA to do reduction in direct and portfolio foreign investment in the public sector, monitoring and control over external borrowing especially short term. In the industrial sector the reforms were - virtual abolition of industrial licenses, separate permission needed by “MRTP houses”, a reduction made in industries reserved for the public sector. In financial sector following reforms were made - reduction in reserve requirement for banks (CRR & SLR), the legislative empowerment of SEBI, abolition of Government control over capital issue. In public sector disinvestment programme has begun and many other reforms has been made like reduction in protection to the manufacturing sector, reduction of the fiscal deficit and major tax reform etc.6

Main focus of reforms launched in 1990s was to encourage the economic growth of the economy. Policy makers believe that if economic policies were liberalized, foreign investment in the country would increase because the changes provide
freedom to foreign investors to enter into Indian industry. In the reform policy of 1990 stress was laid on providing access to capital, technology and market which helps to encourage greater industrial efficiency and incorporation of the domestic economy with the global economy. Over 1997 Indian government tries to push an agenda of integrating Indian financial markets with the rest of the world.

After liberalization import licensing was totally abolished with respect to imports of most machinery, equipment and manufactured intermediate products because import of these products needed for increasing productivity and tariff protection also reduced, relaxed and simplified the restrictive import licensing regime. To encourage domestic and export-oriented growth reforms consisted of reduced control over location restrictions and industrial licensing but imports of consumer goods remained regulated. India’s financial services are gradually being liberalized. While significant progress was made in liberalizing telecommunications and this include other services also such as shipping, roads, ports and airports are beginning to open up.

After liberalization changes has been made in tariff rates also, they has been decreased from 300 percent to 150 percent and further to less than 40 percent by the end of the decade, and the peak duty on capital goods cut to 80 percent. Reforms result into a cut down of rates of customs duty from an average of 97 percent in 1990-91 to 29 percent in 1995-96, whereas tariffs have been reduced from an average of 71 percent in 1993 to 35 percent in 1997 for intermediate, capital and consumer goods from a very complex custom tariff structure in 1991 to general structure which has been simplified., but the tariff structure remained complex and escalation remains high in several industries and restrictions are remained on the negative list. In 2002, customs duties included only four rates (35 percent, 25 percent, 15 percent and 5 percent) and weighted tariff average fell from 75 percent to 25 percent. Reforms take another step forward in 1997 when India presented a programme for the removal of remaining restrictions to its trading partners. These reforms include income tax exemptions, subsidized credit export insurance and guarantees, which resulting in more explicit export-oriented policies. However, in 1996-97, mean tariffs slowly increased.
The tariff continues to remain the principal trade instrument and important source of tax revenue at around 16 percent of Central government tax revenue. Applied MFN tariffs, particularly for non-agricultural products continue to fall steadily, with overall average currently at 15.8 percent. At 12.1 percent the average for non-agricultural products is considerably lower than the average for agricultural products, which is 40.8 percent. The growing gap between agricultural and non-agricultural tariffs has also raised dispersion in the tariff. The difference provides the government scope to raise applied tariffs and in last few years there was increase in tariffs for some agricultural products in recent years. Tariffs are continued to follow the downturn trend and it keep lowering and they reduced to 10 percent from 12.5 percent in 2007. Despite gradual reform over the years, the tariff regime remains complex. There are a number of exemptions, which are based on industrial use. The policy regarding tariff rate quotas remain unchanged since 2002.

India offers tariff preferences under its regional trade agreements. These preferences are not significant. The use of import restrictions has declined, with around 3.5 percent of tariff lines. India continues to be a frequent user of antidumping measures. In recent years, the number of investigations and measures in force has shown a declining trend in sectors like chemicals, plastics, rubber products, base metals and textiles and clothing. In order to reduce the anti-export bias inherent in import and indirect tax regime, a number of duty remission and exemption schemes have been in place to facilitate exports. The schemes are open to all exporters who use imported inputs. Many schemes have been made to promote export of commodities like electronics, farm products, services, facilities like tax holidays has been given to export processing zones, export-oriented units and special economic zones. India made many changes in its new foreign trade policy while taking into consideration on increasing importance of exports and these new policies facilitating those imports which helps to accelerate the economy.

After adopting the policy of liberalization there has been a favourable impact on the overall growth rate of the economy. The growth rate, which was only 3 percent in 1970 even lower than countries like Brazil, Mexico, and Korea have reached 5.9 percent in 1992-93 and 6.2 percent in 1993-94 and crossed 8 percent during the
2003-04. After globalization in India not only GDP has increased, but there were changes in the direction of growth in sectors. Before Globalization maximum part of GDP in the economy was generated from primary sector, but after globalization maximum part came from the service sector and it contributes 57 percent of GDP and India ranked 18th among the leading exporters of the services sector. After reforms not only GDP of the country has increased, but all sectors have seen growth and changes. The service sector is the one which flourishes the most after the reforms. After initial periods of sometimes painful adjustment in the 1990s, Indian industry has succeeded in the more open and competitive environment. The explosion in software, IT enabled service exports are well-known, having risen from nil in 1991 to $ 24 billion in 2005-06. After reforms, small-scale units have benefited greatly from the much freer access to trade raw materials, components and designs. Perhaps most importantly, the old mindset of foreign exchange scarcity has been effectively banished.

1.2.1 AGRICULTURE SECTOR AFTER REFORMS

Agriculture sector’s growth has seen many fluctuations over the reform period. In 1991, share of agricultural exports in the total exports was 17.9 percent, which has increased to nearly 3 percent by the year 1996-97, there after the share was continuously declining, and it reduced to 9.9 percent in 2006-07. Between the year 2006-07 and 2007-08, there was an increase of 2.3 percent. With a fall in 2008-09 to 10.2 percent it has seen a growth of 0.4 percent in 2009-10. There is a need from the government side to make some strategic changes to its policies to improve the growth within the agriculture sector and in the eleventh plan the concern of Government towards the agriculture in which the ambitious 4 percent growth target than agriculture sector must play an important role in it and to accelerate the growth in agriculture sector government set the target of 4 percent per annum which was 2 percent before. Contribution of Indian agricultural export to the total export of India in 2009-10 stood at 9.4 percent. There is an increase as the volume of agricultural export from 3130.08 million USD in 1991-92 to 16753.23 in 2009-10 but the annual growth rate for these 18 years is 9.3 percent.

1.2.2 CAPITAL MARKET AFTER REFORMS
Reforms in the capital market brought many positive changes and helped in the rise of the modernized capital market, and many new companies have emerged stronger. After reforms in 1992, SEBI was empowered consistently to improve standards and transparency. Future markets were nurtured as paperless trading becomes the norm, and brokers were encouraged to corporatize. with the help of a combination of a modernizing capital market new companies has emerged and these companies provided with liberal and competitive environment for investment, trade and production, a wealth of entrepreneurial talent and sustained economic growth. For example, Airtel, the leading private telecom, went from nothing to a multi-billion-dollar company in a decade. The market capitalization of companies listed on the Bombay Stock Exchange rose nearly 14-fold from $ 50 billion in 1990/91 to $ 680 billion in 2005-06. Data for the top 1000 listed companies showed that their profits increased from 4.5 percent in 2001-02 to 8.9 percent in 2004-05. These reforms transformed Indian capital markets into one of the best in the developing world (Business Standard, 2006).

1.2.3 SOFTWARE AND IT-ENABLED SERVICES AFTER REFORMS

The roots of Indian software/business-processing services sector was back into some decisions taken many decades ago and other developments in the more recent past. In early 1950, the first Indian Institute of Technology model on MIT was established at Kharagpur in West Bengal followed by six other IITs. These Institutes of Information Technology were set up in selected cities across the country and these institutions were set up according to the Indian Institute of Technology Act in 1956. Many graduates from the IITs who work abroad or have studied and worked abroad have contributed towards the growth of the IT services industry in three ways. First, North America and the U.K have a positive impact on the quality of their training and their skills. Secondly, after attaining further education and experience abroad, many of these former graduates have returned to India and are setting up their own businesses. And third, the Indian professional and business people have shown great initiative in creating opportunities for Indian firms.8

The service sector has played an important role in their growth of the economy and growth of these industries was organized by a number of medium sized firms
established few decades before and the share of foreign multinationals in top twenty exporters in this sector was not more than one-fourth. There are few reasons which gave Indian firms a good start in the global market and especially in U.S. are (a) the past association dating back to the 1980s and (b) the presence of thousands of Indian professionals in the U.S. The government provide many opportunities which include containing the rates for telecommunication services and modifying India’s strict labour laws to give IT firm’s greater flexibility in the hiring and laying off of workers.

India faces a strong competition in the service sector like - the Eastern European economies, Russia, Brazil, Mexico because middle income countries are also looking for providing the economic momentum and for jobs. China, which is producing more engineers and IT technicians than India, ambitiously expands the ITES and software sectors assisted by FDI by Indian IT firms. Israel, Ireland, several European countries and the U.S. are emerging as a strong competitor of India in service's sector.

Many services in Indian economy, which grew at double-digit rate after reforms are Indian banking, finance, telecommunications, and hotel and restaurants. These services have ample scope to grow at a faster pace because these services have been increasing domestic demand as well as demand from foreign countries. There is a possibility that in coming years, India may emerge as a major exporter of any of these services. Each of these also stands to benefit from advances in IT, which will both raise productivity and generate demand for the firms supplying the services. In finance assets India holds, 1 percent of global shares were less than one–half are in the form of bank deposits.

### 1.3 FOREIGN DIRECT INVESTMENT IN INDIA

Foreign Direct Investment (FDI) is the growth engine for every country especially for developing countries. FDI became very important for developing countries because it became the main source of the capital inflows and FDI helps in the easy access to foreign technology and management skills. As India understands the importance of FDI, it has set up an ‘India Brand Equity Fund’ to attract FDI. There is a tremendous rise in FDI inflows of India from last few years. FDI flow rise from US$5-6 billion in 2003-04 to US$19 billion in 2006-07. However,
India’s FDI share in GDP in 2007 is low as compared to China and Pakistan. Sectors which are mainly attracted FDI in India are electrical equipments, services, drugs and pharmaceuticals, cement and metallurgical and particularly during the period of Augusts 1991 and July 2007 electrical equipment sectors and services sector received the majority shares of total FDI inflows.

Foreign direct investment in India was regulated and restricted until 1990 but in the 1990 government of India introduce economic reforms under these reform policies of industrial licensing has been removed and restrictions on FDI is also removed except on certain sectors, new policies after reforms also cause abolishing of the Monopolies and Restrictive Trade Practices (MRTP) Act and opening up of reserved sectors to foreign investment. In the first phase of economic reforms GOI allowed FDI up to 51 percent through an automatic route. Subsequently, in the second-generation economic reforms were introduced in 1998, FDI was allowed up to 100 percent in many sectors, including Drugs and Pharmaceuticals. The objective of liberalization of policies of Foreign Direct Investment regime was to attract multinational corporations to invest in India. Reserve Bank of India gave automatic approval to most of the policies and procedures and many other sectors were also liberalized and for investment in those sectors they need approval from the Foreign Investment Promotion Board (FIPB). In 1990-91 FDI increased from around US$ 100 million to US$ 5536 million in 2004-05.

1.4 EXPORT AND IMPORT OF INDIA AFTER 1991

In 2003-04, import was increased by 35.62 percent, which stood at US$ 107 billion and exports by 24 percent in 2003-04, which stood at US$ 79 billion in 2004-05 compared to US$ 63 billion in 2003-04. There was an increase in oil import by 19 percent, import was US$ 29.08 billion against US$ 20.59 billion in 2003-04 and non-oil import during 2004-05 was estimated at US$ 77.03 billion, which is 33.62 percent higher than 2003-04. Position of exchange reserves comprising foreign assets, gold, SDRs and reserve position with the IMF has strengthened after policy reforms of 1991 and composition of debt is also favourable. ⁹
In terms of composition currently, India is dominated by manufactured goods and services. Service's export contribution has grown rapidly in the recent past. Share of India in export of services in global export is more than double that of Indian manufacturing export. Now USA has emerged as our leading trade partner followed by other countries. Indian trade is more distributed around the world with the share of East Asian countries on the rise in overall trade. Looking at the growth rate of India and small share in the world trade it is obvious that it has tremendous scope for foreign trade in coming years. The large size of Indian economy with huge untapped potential safely concludes that there is a scope for an increase of foreign trade with other countries.

With the development of the economy, there has been a tremendous change in the composition of India’s imports that shows a decline in imports of food grains and consumer goods and increase in imports of capital goods and raw materials. Presently, the major import of India consists of capital goods, metal and minerals, chemicals, fertilizers, petroleum and lubricants, etc., which are required to meet the development needs of the country. Imports from India in 2011 were US$ 369,769.13 million.  

There was a massive increase in export from 1993 to 1996 and many changes had been made, which include the abolition of industrial licensing, reforms in the financial sector, tax reforms and Indian foreign trade took off its pace, especially after 2002 because the EXIM policy of 1997 -2002 aims at simplified procedure and rationalized tariff rates. 

India’s exports have also gone paradigm change with the industrialization of the economy. At the time of independence, India’s export comprised mainly of agricultural products like tea, spices, tobacco and raw material, but over the period of time it started shifting towards industrial products such as steel, machinery, transport equipment, chemicals, etc. But even presently a large part of commodities, which are exported by India consists of low value added items. Exports have risen to US$ 251,135.89 million till 2011. 

In 1990s, India adopted a trade policy which has proven very helpful in the development of the economy. This trade policy helps India to switch from import substitution and enhance reliance on international trade. The largest trading
partners of India in international trade are China, USA, UAE, South Korea, Canada, and Japan. Trade with China and Japan has played a key role in the development of Technical know-how and in bolstering infrastructure. In order to be further boost bilateral trade between them, these countries have stepped up their efforts to enter into economic partnership at a higher level by utilizing synergies in trade, investment and hi-tech areas.

1.5 JAPANESE ECONOMY

Japan is second-largest economy by nominal GDP (US$ 5.073 trillion) in the world after the United States in 2009 and according to Purchasing Power Parity basis, Japan is the third largest economy in the world after the US and China after the second world war, cooperation between government and industry, a strong work ethic, mastery of high technology and comparatively small allocation helped Japan to develop as a technologically advanced economy. By measuring through nominal methods Japan’s per capita was US$39,573.

Development of Japan was divided into two periods- from 1886 to world war second and the second period was extended from world war second to 1990s. In first-period Japanese economy growth was moderate and relied heavily on traditional agriculture. By the time 65 percent of employment and 38 percent of gross domestic product (GDP) was depended upon agriculture, but Morden industry has begun to expand in 1920, manufacturing and mining contributed 23 percent of GDP compared with 25 percent of agriculture. Transport and communication developed to sustain heavy industrial development.

Major exports of Japanese are Automobiles, consumer electronics, computers, semiconductors, and iron and steel and there are few industries which play a key role in the Japanese economy are mining, nonferrous metals, petrochemicals, pharmaceuticals, bio industry, shipbuilding, aerospace, textiles, and processed foods. The steady performance of the Japanese Industrial sector in 1970’s and 1980’s was a result of high technology industrial growth. This industrial growth of 1970’ and 1980’s leads to the shutdown of some old industry and construction industry took place of these old industries. Together with the construction industry, those older heavy industries employed 34.9 percent of the work force in 1989 (relatively unchanged from 34.8 percent in 1980).
Along with construction industry other industry has grown faster in 1980’s and that industry is a service industry. But, during the same period few sector have losses in agriculture, forestry, mining and transportation. Most industries catered to the domestic market, but exports were important for several key commodities which include commodities are transportation equipment motor vehicles, electrical machinery, general machinery, and metal and metal products and all these commodities have more exports than imports.

When the Japanese economy opened itself to international competition in some industries a new type of industrial development has started and there is a development of heavy and chemical manufacturers. Products, such as automobiles, ships, and machine tools, assumed more importance than textiles and light manufacture but they are continuous to maintain their profitability internationally. Manufacturing and mining grew at the rate of 17 percent between 1965 and 1970. Growth rates moderated to about 8 percent.

The period of growth came to an end with the bursting of the Japanese asset price bubble in 1991. There were many factors involved in the economic stagnation of Japan’s economy, which includes rising dependency ratio with reduce savings, hollowing out of industrial base as large corporations invest in other countries, the failure of Government spending to stimulate the economy as a result of declining multipliers, the emergence of a liquidity trap in financial markets, a decline in the rate of return to capital investment, a credit crunch caused by the accumulation of bad loans in the banking sector, a general disruption of the financial sector in the aftermath of the collapse of the stock market and land speculative bubble and this was followed by the lost decade from 1990 to 2000.13

1.5.1 RELATIONSHIP BETWEEN INDIA AND JAPAN

Trade, economic, diplomatic relation between India and Japan started after the peace treaty of 28th April 1952 and from the last six decades; India and Japan have built up a strong relationship based on understanding and mutual respect. India and Japan celebrated 2007 year as the Year of Friendship between the two countries, and both countries tried to strengthen their bilateral relation through new initiatives and programs, which include economic ties as well as cultural linkages.14
Before signing the peace treaty India tried to improve the relationship with Japan. India refused to attend the San Francisco peace conference in 1951 due to its concerns over the limitations imposed upon Japanese sovereignty and National Independence. After the restoration of Japan's independence a peace treaty was signed and this treaty was one of the first treaties Japan signed after World War II. India's iron ore helped Japan's recovery from World War II devastation and after the visit to India in 1957 Japanese Prime Minister Nobusuke Kishi's started providing yen loans to India in 1957 from the very next year. To strengthen the relationship with Japan, India consider Japan as a key partner under its policy of ‘look east’ because after World War II Japan was a U.S. ally and India’s policies are always leaning towards the Soviet Union. Since 1980s, however, efforts were made to strengthen bilateral ties. India’s ‘Look East’ policy posited Japan as a key partner.

Since 1986, Japan has become India's largest aid donor and remains so. But the relationship between imposition of various sanctions on India, which include the suspension of political assistance and economic assistance, but these sanctions were lifted after three years and after these years bilateral ties between the two nations improved once again. In August 2000 on the visit of Japanese Prime Minister Mori to India, Japan and India agreed to establish "Japan-India Global Partnership in the 21st Century. In December 2001, Indian Prime Minister Vajpayee visited Japan where both Prime Ministers issued "Japan-India Joint Declaration," consisting of high-level dialogue, economic co-operation, and military and anti-terrorism co-operation. In April 2005, Joint Statement was signed between India and Japan on "Japan-India Partnership in the New Asian Era: Strategic Orientation of Japan-India Global Partnership." The 2007 annual survey conducted by the Japan Bank for International Co-operation ranked India as the most promising overseas investment destination for Japanese companies over the long term. In recent years, Japan has assisted India in infrastructure development projects such as the Delhi Metro Rail Project. The Japanese Government has also expressed interest to help in establishing a Chennai-Bangalore Industrial corridor and a Dedicated Freight project in south, connecting the cities of Bangalore and Chennai. In October 2008, Japan signed an agreement with India under which it would provide a low-interest loan worth US$4.5 billion to construct a railway.
project between Delhi and Mumbai. Partnership between the two nations has been seen by the single largest overseas project being financed by Japan. India is also one of the only three countries with whom Japan has a security pact, the other two being Australia and the United States. In March 2006, Japan was the third largest investor in India with an estimated total investment of US$ 2.12 billion. In November 2009, the Japanese steel manufacturer (JFE Steel) agreed to partner with JSW Steel, India’s third-largest steel producer, to construct a joint steel plant in West Bengal. In 2010 Prime Minister Manmohan Singh had visited Japan and after that both countries agreed to foster increased business exchanges, people-to-people contact and signed a memorandum of understanding to simplify visa procedures for each other’s citizens. Under the memorandum, any Japanese coming to India for business or work will be straightway granted a three-year visa and similar procedures will be followed by Japan. Other highlights of this visit include abolition of customs duties on 94 percent of trade between the two nations over the next decade. As per the agreement, tariffs will be removed on almost 90 percent of Japan's exports to India and 97 percent of India's exports to Japan.

Japan moved between the 2nd and 3rd positions between the periods of 1989 to 1997 in terms of India’s export destination, but it fell to the 6th position in 1998 and 10th in 2005 before rising again to the 8th position in 2006 and 13th position in 2011. Shift in manufacturing bases from Japan to China and ASEAN countries became a cause of these changes in a position of Japan as a trading partner. The US occupied the top position of a supplier of goods to India from 1989 to 2003 and a second position since 2003. Japan was 4th in terms of India’s imports from 1989 to 1991 but has fallen steadily to 7th in 2001, 8th between 2002 and 2003, 10th in 2004 and 2005 and 11th in 2006. Between the periods of 1989-2006, the share of India’s exports to Japan declined rapidly while that to China increased. In 1989, the share of India’s exports to Japan was 13.49 percent, but it declined steadily to just 2.43 percent in 2005, rebounding slightly to 3.05 percent in 2006. The share of India’s imports from Japan was 7.74 percent in 1989, but it declined over the years, touching 2.58 percent in 2005 before rising to 2.67 percent in 2006. In contrast, the share of India’s imports from the Chinese Mainland was 0.20 percent in 1989, and it increased steadily, reaching 8.67 percent in 2006.
India has never been among Japan’s top 20 export destinations during the period from 1989 to 2006. Instead US, the top export destination of Japan and South Korea fluctuated between the 2nd and 3rd positions. The PRC was the 7th top export destination of Japan in 1989, 11th in 1990, 5th in 1993 and 1995, 4th from 1996 to 1997 and has been 2nd since 2001. India has never been among the top 20 suppliers in Japan. In 1989, India ranked 23rd, 21st between 1993 and 1994, 28th in 2004, 27th in 2005, and 26th in 2006. The US was again the top exporter to Japan from 1989 to 2001, giving way to China since 2001, which had been ranked 2nd from 1991 to 2001. Share of Japan’s export to India had been always below one percent and in fact, declined marginally between 1989 and 2006. The share of Japan’s import from India was 0.94 percent in 1989, but it steadily decreased to 0.71 percent in 2006.

The major goods traded between India and Japan did not appear to have been much change in their composition from 1970 to 2006. In 2006, the major items exported from India include mineral fuels, mineral oil, gems and jewellery, ores, slag and ash, while the major imports include machinery, electrical machinery, and iron and steel. Indo-Japanese business cooperation rapidly fell after India’s nuclear test in 1998 but has picked up after 2011.16

1.5.2 JAPANESE OVERSEAS DEVELOPMENT ASSISTANCE

India received massive support from the Japanese Government in the form of large overseas development assistance. After adopting the policy of liberalization in 1991 the share of Japan in India’s global trade is declining and the investment done by Japan in India also getting low when it is compared to other countries but in recent past it has been rising. According to Japan Bank of International Cooperation Survey of Japanese manufacturers done in 2010 has placed India as the most attractive FDI destination in Japan over the long term ahead of China. In the recent period, there is an expansion of Japanese companies in India; Japanese firms in India have grown from 438 in January 2008 to 725 in October 2010 and Japanese offices from 555 to 1236 in the same period. Instead of increasing Foreign Direct Investment from Japan, India is still getting low FDI as compared to other countries and there are many reasons, which lead to low Japanese FDI are – lack of knowledge and information about each other’s market, language and
cultural barriers. Information gap between two countries bridged leading the way to increased trade and investment between the countries.\textsuperscript{17}

**Overseas Development Assistance (ODA)**

Japan is providing Official Development Assistance to India and it comes out to be an important aspect of Indo-Japanese economic relations. India is start receiving its ODA from Japan in form of yen loans in 1958. This was Japan’s first case of yen loans since the beginning of its ODA policy in 1952. Since then most ODA (95 percent of the total) has been in the form of yen loans.

Since 1986 Japan has become the India’s largest aid donor. India received a low-interest rate loan worth US$4.5 billion to construct a railway project between Delhi and Mumbai under an agreement signed between India and Japan on October 2008. This overseas project, which is financed by Japan is the largest overseas project, which reflected that economy between India and Japan is growing. Japan has security pact only with three countries, namely India, Australia and the United States. There is an agreement between Japan and India and according to this agreement; both countries have to abolish custom duties on 94 percent of trade. As per the agreement, tariffs will be removed on almost 90 percent of India’s imports from Japan and 97 percent of India’s exports to Japan.\textsuperscript{18}

India is received Japanese yen loan through the Japan Bank for International Co-operation (JBIC) while India is getting grants aid and technical co-operation from Japan International Co-operation Agency (JICA). From 2003 to 2008 India receives the maximum number of Japanese soft loan assistance as compared to any other country. Japan is raising its yen loan year after year for India even when its budget has come under severe strain and this raise the hope of growing partnership between India and Japan. During the year 2006-07, India received ODA loans for 11 projects worth ¥184.9 billion from Japan during 2006-07 and it is 18.9 percent more than what was agreed in 2005-06 above what was agreed to in 2005-06. Japanese gave the record loan to India in 2007 it almost touched ¥225,130 million. The loans which were given by Japan under ODA soft loan package which covers four large projects in the areas of transportation, environment and finance and the amount which were given in this package was about ¥99,019 million. Japan also provides concessional loan to India and it is given through the Japan International
Cooperation Agency (JICA) and repayment period of between 15 and 30 years, including the grace period and interest rates on these loans ranging from 0.3 percent to 1.2 percent per annum. The Chennai Metro Project and the Micro, Small and Medium Enterprises Energy Saving Project deserve special mention. Japan also proposed to assist infrastructure development that contributes to private investment-oriented economic development. In case when Japan has to do investment it attaches priority to the power and transport sectors. It also intends to provide assistance for the health and sanitation sector, local development, development of tourism that contributes to employment, disaster prevention and tackling problem of environmental pollution. To address environmental concerns, ODA will be directed towards providing assistance to improve water supply and sewage systems, afforestation programmes, renewable energy and energy saving projects, urban environment improvement projects and environmental conservation of rivers and lakes. One of the important goals of Japan’s ODA to India is to boost mutual understanding between the two countries. To achieve this area which is involving technology required a substantial increase in people-to-people contact therefore in the areas of human resource development Japan will collaborate with the private sector, youth invitation programmes, the Japan Overseas Co-operation Volunteers (JO CV) programme, and the India-Japan intellectual exchange programme. 19

Following are the project in which India receives overseas development assistance by Japan:

**Transport:**

India and Japan Changing Dimensions of Partnership in the post-Cold War Period

a) Delhi Mass Rapid Transport System Project: Phase 1 and 2

b) Kolkata East-West Metro Project

c) Bangalore Metro Rail Project

d) Chennai Metro Project

e) Hyderabad Outer Ring Road Project Phase 1
Water Supply:

a) The Guwahati Water Supply Project
b) Hogenakkal Water Supply & Flurosis Mitigation Project, Tamilnadu
c) Kerala Water Supply Phase 1-3.
d) Agra Water Supply Project
e) Bangalore Water Supply and Sewerage: Phase 1 and 2
f) Goa Water and Sewerage Project
g) Amritsar Sewerage Project, Punjab
h) Bisalpur-Jaipur Water Supply Project, Rajasthan
i) Rajasthan Minor Irrigation Improvement
j) Hussain Sagar Lake and Catchment Area Improvement Project, Andhra Pradesh
k) KC Canal Modernization Project II, Andhra Pradesh

Power projects:

a) Simhadri & Vizag Transmission system, Andhra Pradesh
b) Transmission system and modernization project in Hyderabad, AP.
c) West Bengal Transmission System Project II
d) Bakreswar Thermal Power Station Unit Extension, West Bengal
e) Purulia Pumped Storage Project II, West Bengal
f) Maharashtra Transmission System Project
g) Bangalore Distribution Up gradation Project
h) Tuirial Hydro Electric Power Project, Central Mizoram
i) Dhauliganga Power Plant Construction, Central Uttarkhand
j) Umium Stage II Hydro Power Station

k) Karanpura Super Thermal Power Project, Central Jharkhand

l) Rural Electrification Project in AP, Madhya Pradesh and Maharashtra

**Forestry and environment:**

a) Orissa Forestry Sector Development Project

b) Karnataka Sustainable Forest Management and Biodiversity Conservation Project

c) Integrated Natural Resource Management and Poverty Reduction, Haryana

d) Tamilnadu Afforestation Project III

e) Tripura Forest Environmental Improvement and Poverty Alleviation

f) Gujarat Forestry Development Project Phase II

g) Swan River Integrated Watershed Management Project

**Two Flagship Projects:** Japan has closely associated it with India's two mega projects which would give a huge boost to investment and industrial progress. Indian government visualizes the construction of Delhi Mumbai Industrial Freight Corridor, which helps in the super speed connectivity for high axle load wagons. Covering a distance of 1483 kilometers between Delhi and the Jawaharlal Nehru Port, Mumbai, it will pass through six states the Uttar Pradesh, Delhi, Haryana, Rajasthan, Gujarat, and Maharashtra. It is planned to develop an industrial corridor on both sides of the freight corridor covering an area of about 150 kilometres on each side. The Indian government seems that this project becomes a global investment and manufacturing destination because government try to expand manufacturing and services base on this corridor. The DMIC proposes to establish 24 nodes or industrial and investment zones that would cover six states. Showing great interest in the two projects, Japan has recently signed two agreements with India. The first Memorandum of understanding signed between the DMICDP and the Japan External Trade Organization (JETRO) and Memorandum relates to the setting up of 24 eco-cities and smart communities in
the specified project areas. The second agreement concerns a loan of $75 million from the Japan International Cooperation Agency (JICA) as a project development fund to quickly start the project. The DMIC has already aroused a great deal of enthusiasm among many Japanese business houses that look forward to the opportunities and investment.  

1.5.3. FOREIGN DIRECT INVESTMENT BY JAPAN

Indo-Japanese relations have undergone tremendous changes and both countries tried to build a global partnership. One of the main reasons of Japanese investment in India is the growing potential of local market. Japan has remained one of the top ten investors in India since 1990’s. Japan’s contribution to India’s FDI inflows was only 4.29 percent of total FDI inflows in India between 1991 and 2007. Investment flows have generally fluctuated but increased in 2002 and then once again decreased till 2006 and then again rose in 2007.

Japanese investment began in the mid-80s with Suzuki’s joint venture with the state-owned Indian automotive company ‘Maruti Udyog’. The partnership saw the launch of Maruti Suzuki which became one of the India’s leading car manufacturers. Recently most of the leading Japanese automotive manufacturers entered the Indian market in the two wheelers, passenger cars and commercial vehicle segments. 100 percent FDI is allowed under automatic route. There is no regional concentration of Japanese Automobile companies, but states such as Haryana have proved particularly attractive to new entrants. In the last five years there had been at least eight major investments by Japanese auto companies with a value of INR 1.2 billion.

Japan’s FDI in India is divided into two phases – first is from post liberalization period i.e. from 1991 to 2000 and second phase is from 2000 to till now. In first phase only 49 percent of equity participation of foreign companies is allowed and it is also limited to few sectors only. After liberalization FDI is regarded as a supply of scarce capital and India improved its own policies to attract FDI by permitting it in almost all sectors. Although India received low direct investment from Japan, but still it is important investor in India. During the period of 1991-1999 India received US$ 2.6 billion in the form of FDI inflows. Japan was in the
fourth position with total FDI shares of 4 percent. US, Mauritius and UK were ahead of Japan in direct investment in India.

In the second phase, there was an increase in FDI flows from Japan in 2002 and reached at US$ 412.60 million, but it felt to US$ 94.4 million in the year 2003. The next few years showed some improvement in FDI flows from Japan, but in the last few years there is rapid increase in FDI flows from Japan. Although there is an increase in FDI flows from Japan, but in this decade Japanese position slipped from fourth to sixth and Singapore which in the last decade was nowhere in picture hold the second position after Mauritius in FDI flows into India. Many changes have been made in the policies in year 2000 and foreign participation being allowed up to 100 percent in almost all sectors. Again in 2005 another change has been made according to which foreign companies that are already operating in one sector were allowed to re-invest in another sector through automatic route.22

Approximately 10 percent of Japanese technical collaborations in India have been in the chemical industry (August 1991-March 2006). In 2000 Mitsubishi Chemical Corporations established an Indian operation with an investment of INR 14.8 billion, the largest Japanese investment in the chemical industry.

The first Japanese investment in the electronics industry began in the early 1990s with the entry of players such as Toshiba, Sony, and Panasonic. The electronic industry accounts for approximately 7 percent of investment and financial companies invest an amount of INR 88.7 billion from 2000 to 2005. During these years, there have been 3 major deals including the Matsushita’s investment of INR 2 billion to acquire 80 percent stake in Anchor electronics in India.

Japanese companies have been active technology suppliers to India IT companies (837 collaborations in 2006 alone), particularly investing in Tier 1 cities because of their better Infrastructure, IT Special Economic Zones and arks. They have also moved from being hardware suppliers in developing joint ventures and partnerships for the development of software and related. Media sector had relatively limited investment from Japanese companies as compared to marketing service industry.
Mauritius has been the largest direct investor in India (investing 20 billion in India), second is US (6 billion – 12 percent of total FDI) followed by UK and Netherlands. Japan is the fifth largest source of cumulative FDI in India. India, however continues to be one of the biggest recipients of Japanese ODA. Most of the assistance has been in building, infrastructure, including electricity generation, transportation and water supply. 19

1.6 CHINESE ECONOMY

China is one of the leading economies in the world and it has a significant role in the trade of the Indian economy. China has the oldest civilization in the world history and Chinese economic history had watched the different cycles of prosperity and decline. After the First World War Chinese domestic industries developed rapidly and there is an increase in the demand of Chinese goods. Chinese export has increased which is shown by the increase in Chinese textile industry from 482,192 needle machines in 1913 to 647,570 in 1918 (the end of the war). The number rose even faster to 1,248,282 by 1921. There was a movement in China, which affected in a decrease of imports from China in these movements Chinese students called China’s population to boycott foreign goods which also helped to prompt development. Chinese foreign import fell drastically from 1919–1921 and from 1925 to 1927. After the collapse of the Qing dynasty China virtually disintegrated into regions and they were fighting for authority, leading to economic misery and contraction. In 1927 Chiang reunified different regions of China and announced himself as its leader. Chiang brought economic and political stability in China. After 1927, Chinese industries continue to develop with the advent of the Nanking decade in the 1930s.

In 1937, the Japanese invaded and literally laid China to waste eight years in war. Most of the prosperous East China coast was occupied by the Japanese and in this war, all was destroyed that Chiang had built up in the preceding decade. Industrial sector of China was severely hampered by devastating conflict, it stops the development of industries and inflow of cheap American goods is another reason for the dire situation of industries in China. By 1946 Chinese industries operated at 20 percent capacity and had 25 percent of the output of pre-war China. The era
also saw the first boycott of Japanese products; the Chinese civil war further devastated China and led to fall of the Republic in 1949.

Mao era (1949-1976) was started after the fall of the Republic in 1949. During this period Chinese economy was based on Soviet style planned economy. A decade of relatively peaceful development and collectivization followed, but in 1959 Mao launched the disastrous Great Leap Forward, an attempt to collectivize all aspects of life (even the peasants' cooking pots), a disaster that was exacerbated by famine. A reform group led by Deng Xiaoping and Liu Shaoqi forced Mao to do an experiment with market reforms such as giving peasants private plots. However, these reform efforts were disrupted by Mao's Cultural Revolution, a period of virtually total anarchy and street fighting that resulted in the collapse of the Chinese economy and ended with the arrest of the Gang of Four.

At the end of the Cultural Revolution Chinese economy was in worse condition and its people barely surviving, the country was to witness the most rapid periods of change in the next two years which it has never seen in its history. Free-market reforms have initiated and that transformed the Chinese economy. In 1979, China moved from being an economically deserted country and turn out to be an industrial powerhouse in 2000, rapidly overtaking developed western nations and becoming second largest economy in the world in 2011.

After liberalization, many economic activities which are banned during the Mao era were reinstated like private business, self employed households, and contracting system. These self employed households quickly became extremely wealthy. In 1990’s, many state enterprises were privatized and private individuals were allowed to create companies. In 1990 Shanghai Stock Exchange was reopened after 41 years of its closure by Mao. In the 1980’s and 1990’s government shifts its operation in private sector which include many schools, hospitals and even bus lines. However, this system was also criticized as many felt that change in the operation of these schools and hospitals for profit was detrimental to the poor section.

There was an establishment of Special Economic Zones (SEZ) in which foreigners could invest in China taking advantage of lower labour costs. This investment helped the Chinese economy to boom. To boost the economy, Chinese start a
series of joint ventures with foreign countries and invite them to establish companies and industries until now unknown in China. Year of 2001 became a benchmark in the growth of Chinese economy when it became a member of World Trade Organization, which has boosted its overall trade in exports/imports—estimated at $851 billion in 2003—by an additional $170 billion than a previous year.

Deng's liberalization of the Chinese economy along with foreign investment helped to power China's industrialization. From virtually an industrial backward in 1978, China is now the world's biggest producer of concrete, steel, ships, textiles as well as the world's biggest auto market. For example, from 2000 to 2006 China's steel production rose from 140 million tons to 416 million tons. In February 2011, official economic statistics issued by Japan showed its GDP worth $5.474 trillion in 2010, when China's GDP was around $5.8 trillion.

China’s rank has risen steadily from the thirties largest trading country in 1997 when Chinese reforms had started to seventh largest trading country in 2000. The value of Chinese export rose from 20 percent to 35 percent of GDP during the period of 2000-2007. In 2009 China became second largest exporter country of the world while in 2010 China became the second largest economy of the world. China’s export growth was concentrated in specific sectors like machinery, textile, steel, furniture and apparel.  

Electrical and electronic equipments and nuclear reactors, boiler and machinery had been the top exported commodities of China during the period of 1998-2007. The export of these two commodities hugely increased in the more recent period of 2002-2007. Export apparel clothing and textile and Chemicals constituted the third and fourth largest commodity group with their proportion in total Chinese exports. In the later period, commodities like optical, photo, technical, medical, articles of iron or steel became more important with increased their share in the total export of China and there are other commodities which has lost their share to these new set of commodities despite the increase in their trade values were—footwear, gaiters, and their parts like toys, games, sports requisites, which were labour intensive and low-technology exports and also minerals, fuel, oils and
distillation products. There is a change in china’s export structure, it has shifted its export from low end manufacturing goods to high end manufacturing goods.

Electrical equipments and electronic goods taken together increased their share in China’s total import from 38 percent during 1998-2001 to 41 percent during 2007. However, this increase in the combined share of these two commodities is solely because of the increase in the share of the commodity group electrical and electronic equipments, which increased its share from 21 percent in the period 1998-2001 to 26.4 percent during the period 2002-07.

There is a substantial diversification in the direction of trade of Chinese economy. Developed countries play the dominant role as the export destination for Chinese export whereas markets of developing countries plays an important source for the imports of Chinese economy. Since 2000 there has been a slight fall in the share of developed countries in Chinese merchandise exports, but they still continue to occupy themselves as a dominant player in China’s export destination accounting for around 55 percent of the total merchandise exports. Chinese exports to developing countries of Asia are not only much lower at around 34 percent, but also appear to have fallen compared to the late 1990s. Japan has also seen a fall in the share as the export destination of China’s export while US and EU has increased their share.

The group of five countries - USA, Hong Kong, Japan, South Korea and Germany constituted the 51.3 percent of total exports of China to the world in 2007 but there is a fall in the share of these countries in recent years especially since 2002. Among these countries, Japan registered a drastic fall in its share from 16.9 percent to 8.4 percent and Hong Kong share had fallen from 17.5 percent to 15.1 percent in 2007. But during these years more or less these five countries remain the major export destination for China. Within Asian countries, Singapore remains the major destination for the export of Chinese goods, although in recent years share of India increased significantly.

There is much greater diversification in the China’s source of imports. China’s import has branched out towards the developing countries, especially of Asia. Developed countries have seen the declining share in China’s import from 52 percent in 1998 to 37 percent in 2006 and at the same time as that of developing
countries increased from 46 percent in 1998 to 53 percent in 2006. The increasing trend of import towards developing countries has specifically started from 2000 onwards.

Since 1979 China has experienced a growth in Foreign Direct Investment and this growth have average growth rate of 38.7 percent per year but there are considerable fluctuations at different times also, which in large part reflect adjustments in the Chinese Government’s economic policies and resulting changes in the investment environment. The development of Foreign Direct Investment in China has undergone through three phases.

**Phase I:** The first phase of Foreign Direct Investment started from 1979 to 1985. This was the initial stage of foreign investment in China starts with the promulgation of the Joint Venture Law by the Chinese Government in 1979 and the setting up of organizations of four Special Economic Zones. In order to spread Foreign Direct Investment from SEZs to other regions Chinese Government made a policy in 1984. According to this policy 14 coastal cities were opened to foreign investment and led to the first boom of FDI in 1984-85.

**Phase II:** This phase started from 1986 to 1989 and before second phase China faced a decline in Foreign Direct Investment. In October 1986 Chinese Government makes a policy for the Encouragement of Foreign Investment which was consisted of some set of central regulations to implement them with the help of provisional and municipal level regulations. These provisions and regulations clarified the legal environment for FDI and also provided solutions to some major problems facing foreign invested enterprises such as foreign exchange imbalance. Chinese government gives many incentives to encourage foreign investment in high technology industries like extra tax benefits and other incentives were offered to all coastal region’s Economic and Technology Development Zones. The new adopted policy of the Government improved investment and promoted a quick recovery of FDI after 1986. In comparison to the first phase of liberalization almost 70 percent of the FDI projects were involved in manufacturing industries during the second phase.

**Phase III:** This phase started from 1990 onwards. To increase the Foreign Direct Investment amendment were issued under the Joint Venture Law in April 1990
which revised several rules which were designed to encourage investment. Since 1992 Chinese Government adopted the ‘Socialist Market Economy’ tax law strategy to speed up the market oriented reforms. Many commercial laws and regulations were passed to improve the legal framework and policy setting in which foreign business operated. As a result of these amendments in Foreign Investment Rules investment surged after 1992. In 1994 Chinese Government presented some new features to increase foreign investment. The average capital size of foreign investment projects increased, with the main focus shifting to large infrastructure and manufacturing projects. The most far-reaching FDI liberalization was the decision in 1999–2001 to accede to the terms of World Trade Organization (WTO). Under WTO accession terms China was obligated to eliminate all import quotas by 2006 and till 2005 all tariffs were removed on commodities like computers, semiconductors, and related products by 2005. There was a decline of tariffs from 24.6 percent to 9.4 percent for industrial products, whereas on motor vehicle it declined from 80 percent to 25 percent by 2006. Foreign firms would be allowed to own up to 50 percent of FIEs.\textsuperscript{25}

Over the past decade, China has benefited from being the fastest sustained economic development by recording high real per capita growth. Its rapid economic growth has made China more attractive to market oriented FDI. Chinese government formulated laws and regulations specially to attract foreign investment. China offered many incentives to foreign investors which are not available even to domestic Chinese firms like an exemption of income tax for the foreign firms over the last two decades.

China is getting far more FDI than India and there are many reasons behind the less foreign investment in India one is that there has been late initiation of economic reforms in India in the year 1991, whereas market based reforms in China were started in 1978 there reforms concentrated heavily on different issues such as banking sector, tax reforms, state-owned enterprises, insurance and sound financial system but in India reforms in these areas of fiscal consolidation, openness of the economy, tax reforms, foreign investment policy, and the financial sector are lacking behind. When China becomes a member of the world trade organization which make it very attractive destination for foreign investors. China has better infrastructure whereas India is lacking behind in this sector.
One of the significant reasons to attract FDI is the availability of production factors like developed human resources, land, natural resources, unutilized production potential, marketing facilities, sources of raw material, financial resources, cheap and skilled labour force etc. Technology imports and Technology Transfer (TT) are another factor which causes more investment in China and in order to promote industrial upgrading and restructuring China strongly encouraged technology sector. For attracting FDI in China, government of China has been spending a lot on imports of Technology, advanced machinery, and equipment, but India is lacking behind to make serious efforts toward this factor.

Political situation in China also helps in attracting foreign investors because there is a dictatorship of one party with a single individual wielding vast power which make it comparatively easier in China to formulate and implement policies and practices regarding FDI. Whereas, the Indian political system is a complex federal democracy with power so widely diffused among different political parties at central and state level, which make a difficult situation for policy makers to make policies which is accepted to coalition govt often and to bring general consensus among all the political parties with varied ideologies to accept and implement the idea of a liberalized policy framework in order to attract foreign investors 26

Data related to FDI in India is not competent when it comes to compare it with other countries and the main reason behind this is the failure of India to adopt international guidelines on measuring FDI statistics. China’s reinvested earnings and intra-company loans together accounted for about 30 percent of total FDI inflows during 1997. Accounting for these components in FDI statistics would bring India’s FDI figure much closer to those in China.27

1.6.1. TRADE BETWEEN INDIA AND CHINA

India and China are two oldest civilizations of the world and in the past both countries did trade through Silk Road, which was the trade route between the two countries and now-a-days China is one of the important trading partners in India. In late 1970’s Chinese leaders decided to open up their economy in the outer world, they decided to take a programme of gradual but fundamental reforms of the economic system. The first few years of reforms were designated as a period of readjustment during which Chinese Government attempted to correct the
imbalances to expand export rapidly. In twentieth century, almost eighty percent of the total border trade volume between India and China is through Nathula pass.

Since early 1950’s, relationship between India and China has not been friendly because of border and military conflicts in past. But over the last three decades both countries open up their economies for other countries and during these years, both countries have made themselves as a key player in the global economy. Over the last two decades, China has recorded the highest rate of growth of exports. Overall growth rate of China averaged 17 percent during the period of 1980-2006. China’s share in world export rises from 0.98 percent in 1998 to 8.1 percent in 2006.

Trade between both countries had suffered a lot after Sino-India war of 1962. After many years few steps have been taken to start trade between both countries when Indian Prime Minister Rajiv Gandhi visit China in 1988 and Chinese prime ministers visit India in 1991. In 1984 India and China signed a trade agreement for providing Most Favoured Nation (MFN) treatment and after thirty years border trade between India and China resumed in July 1992. Substantial movement in relations continued in 1993. Prime Minister Narasimha Rao and Premier Li Peng signed the border agreement and three other agreements primarily dealing with cross-border trade, increased cooperation on environmental issues and agree on radio and television broadcasting. Nuclear test by India in 1998 proves a big setback for the relationship between India and China. Year 2004 witnessed a gradual improvement in the international area when the two countries proposed opening up the Nathu la and Jelepla Passes in Sikkim which would be mutually beneficial to both countries. The same year was a milestone in Sino-Indian bilateral trade, surpassing the US$10 billion mark for the first time. Bilateral trade between the two countries has increased for next few years and reached US$73 billion in 2011, but it slipped to US$66 billion in 2012.

There is an increase in bilateral trade and economic cooperation between India and China especially after 1991. After an increase in trade many Indian entrepreneurs viewed the huge and growing Chinese market as a commercial opportunity. Indian companies started investing in Chinese companies, setting up Chinese operations to service both their Indian and MNC clientele in China. As a result, in the past
decade bilateral trade between China and India has increased dramatically rising from about US$300 million in 1992 to about US$2 billion in 1997 which further risen to US$12 billion in 2004. China has been the second largest market for Indian exports since 2003.

The trade composition of India and China shows that there is a presence of strong complementarities between two economies having similar factor endowments, but well differentiated economic structures. According to the Standard International Trade Classification system; trade in four commodity groups has dominated bilateral trade between China and India. These commodities are crude materials, inedible etc. (except fuels) chemicals and related products, manufactured goods classified chiefly by material and machinery and transport equipment. These groups together accounted for 84.3 percent of China’s exports to India and 96.2 percent of China’s imports from India. There is a considerable change in the pattern of bilateral trade between the two countries in the past decade. Trade in crude materials used to have the largest share amounting to 37.18 percent of China’s exports to India and 61.73 percent of China’s imports from India in 1992. By 2003 share of crude material have shrunk to a large extent, especially for China’s export to India and instead of that trade in manufactured goods and transport equipment has become more important, though China’s imports of Indian crude materials still have the largest share.

The economic relationship between India and China is considered to be one of the most significant bilateral relations in the contemporary global economic scenario and this trend is expected to continue in the years to come. China is the single largest trading partner of India. Major imports from China include electronic goods, coal, coke, briquettes, organic chemicals, machinery, medicinal and pharmaceutical products. Imports from China share accounted 0.82 percent in 1990-91 of the Indian total import; this share has risen to 4.66 percent in 2000-01 and to 13.94 in 2011-12. In terms of value, import from China was worth US$ 196.6 million in 1990-91 which increased to US$ 68248.6 million in 2011-12. During this period, 28.5 percent per annum growth was registered. India’s trade with China is greater than that of Japan, US or any other country.
India and China have signed many agreements in recent past to boost trade between them and have successfully rejuvenated their economic and political ties. Trade relations between the countries has improved and now China is largest trading partners of India. Bilateral trade with China crossed US$13.6 billion in 2004, US $'18.7 billion in 2005 which has reached US$73 billion in 2011. Trade between India and China got a boost in 2006 when both countries started border trade between Tibet (an autonomous region of China) and India through Nathu La Pass (which was opened again after forty years).

Leaders of both countries have decided to boost the bilateral trade to US$30 billion in 2008 and then to US$ 40 billion till 2010 but in 2011 trade between two countries reach US$61.6 billion. India’s import from China is of US$40.8 billion and India’s export to China is of US$20.8 billion in 2011. Value of India’s import on May 2011was US$ 40.90695 billion and of export was US$ 25.94128 billion. India is the 7th largest export partner of China.

Instead of many military and border disputes, looking at the size and growth of both countries, there is ample scope of economic cooperation and trade between two countries. India and China signed many bilateral agreements and regional agreements to develop economic relations with the rest of the Asian countries. 31 Trade agreement of 1984 imparted most favoured nation treatment and after that both countries have signed another agreement in 1994 to preclude double taxation. India and China have also signed various CSBM Agreements to close economic and military ties. In 1971 India signed a treaty of peace, friendship and cooperation with China to have close economic and military ties. Both nations announced a strategic partnership in 2005.32

India’s share in world trade is low as compared to other Asian countries like China (more than 5percent), Malaysia, Korea (about 2.5 percent) and Thailand. There is a need to enhance the volume of India’s trade with the rest of the world. There is an increase between the trade of China and India and it increased almost 46 percent in 2003-04 as compared to 2002-03 last year and in recent years it increasing at a much faster pace. There is vast potential for expansion in India-China bilateral trade. According to Gravity Model trade potential is 2.5 times more than the actual trade between India and China.
1.7 OBJECTIVES OF THE STUDY

Following objectives were laid down for the given study:

To analyze the trends in the volume of trade with Japan and China since 1991;
To analyze the trends and composition of Japanese Foreign Direct Investment in India;
To find out the cause of China’s increasing trade with India;
To analyze the changes in composition of India’s foreign trade with Japan and China.

1.8 HYPOTHESIS

Japanese export to India reflects Japanese foreign direct investment in India.
India’s Export to China has driven by growth of Chinese Economy.
China’s Export to India is the result of Chinese competitiveness.

1.9 RESEARCH METHODOLOGY

The given research work is both theoretical and analytical. Therefore, data for the research work have been collected from diverse sources. Textual and statistical material will be compiled related to the research work and obtained mainly from the Directorate General of Commercial Intelligence and Statistics. Published material related to subject2 is obtained from Newspapers, journals, magazines and reports. Unpublished material relating to subject obtained from Ministry of commerce and industry, Government of India and other institution related to trade data and statistics.

For the purpose of analysis of the data collected through various resources Granger Casualty Test has been applied to test aforementioned hypotheses.

The Granger causality test is a statistical hypothesis test for determining whether one time series is useful in forecasting another. Ordinarily, regressions reflect mere correlations, but Clive Granger argued that causality in economics could be tested for by measuring the ability to predict the future values of a time series using prior values of another time series.
A time series $X$ is said to Granger-cause $Y$ if it can be shown, usually through a series of t-tests and F-tests on lagged values of $X$ and with lagged values of $Y$ also included, that those $X$ values provide statistically significant information about future values of $Y$.

If a time series is a stationary process, the test is performed using the level values of two or more variables. If the variables are non-stationary, then the test is done using first or higher differences. Any particular lagged value of one of the variables is retained in the regression if (1) it is significant according to t-test, (2) it and the other lagged values of the variable jointly add explanatory power to the model according to an F-test. Then the null hypothesis of no Granger causality is not rejected if and only if no lagged values of an explanatory variable have been retained in the regression.

**Mathematical statement**

Let $y$ and $x$ be stationary time series. To test the null hypothesis that $x$ does not Granger-cause $y$, one first finds the proper lagged values of $y$ to include in a univariate auto regression of $y$:

$$Y_t = a_0 + a_1 Y_{t-1} + a_2 Y_{t-2} + \ldots + a_m Y_{t-m} + \text{residual}_t$$

Next, the auto regression is augmented by including lagged values of $x$:

$$Y_t = a_0 + a_1 Y_{t-1} + a_2 Y_{t-2} + \ldots + a_m Y_{t-m} + b_{p} x_{t-p} + \ldots + b_{q} x_{t-q} + \text{residual}_t$$

One retains in this regression all lagged values of $x$ that are individually significant according to their t-statistics, provided that collectively they add explanatory power to the regression according to an F-test (whose null hypothesis is no explanatory power jointly added by the $x$'s). In the notation of the above augmented regression, $p$ is the shortest, and $q$ is the longest, lag length for which the lagged value of $x$ is significant. The null hypothesis that $x$ does not Granger-cause $y$ is not rejected if and only if no lagged values of $x$ are retained in the regression.

The **Herfindahl index** is a measure of the size of firms in relation to the industry and an indicator of the amount of competition among them. The major benefit of the Herfindahl index in relationship to such measures as the concentration ratio is that it gives more weight. It is used to measure the concentration of Chinese export in India.
**Formula of Herfindhal Index**

\[ H = \sum_{i=1}^{N} s_i^2 \]

Where \( s_i \) is the market share of firm \( i \) in the market and \( N \) is the number of firms. Thus, in a market with two firms that each have 50 percent market share, the Herfindahl index equals \( 0.50^2 + 0.50^2 = 1/2 \).

The Herfindahl Index (\( H \)) ranges from \( 1/N \) to one, where \( N \) is the number of firms in the market. Equivalently, if percents are used as whole numbers, as in 75 instead of 0.75, the index can range up to \( 100^2 \), or 10,000.

An \( H \) below 0.01 (or 100) indicates a highly competitive index. An \( H \) below 0.15 (or 1,500) indicates an un-concentrated index. An \( H \) between 0.15 to 0.25 (or 1,500 to 2,500) indicates moderate concentration. An \( H \) above 0.25 (above 2,500) indicates high concentration

**1.10 LIMITATIONS OF THE STUDY**

The present study suffers with many limitations but these limitations are not so serious to defeat the purpose of the study. In the present study we have made use of secondary data. Secondary data have taken from various original and secondary sources and thus, the authenticity of data used depends heavily on the reliability of the source and it is obvious that there are some differences in the reliability of the figures and information themselves. Due to statistical inconsistencies and inadequacies, even the studies conducted by different economist are not free from data limitations. In spite of these discrepancies and inconsistencies regarding data, a humble attempt has been made to study the changing pattern and direction of India’s trade with Japan and China since 1991.
END NOTES


10. India’s Foreign Trade, 2011.


12. India’s Foreign Trade, 2011


the 19th international Input-Output Conference of the Input-Output Association to be held at Alexandria VA, USA, from 13-17 June 2011.


