Introduction

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Chapter I

Introduction
Foreign trade occupies an important place in any economy and its role in the world economy has increased over the past 50 years. Trade has grown much faster than world output and some of the countries have achieved the fastest economic growth by rapidly increasing their role in world trade. So as to increase their share in world trade different, countries adopted various trade policies in different times. Developed countries mainly followed export promotion measures but developing countries adopted import substitution policies in 1950s, 1960s and 1970s. But the experiences showed that import substitution policies widely used by the developing countries were less successful than the export oriented policies used in East Asia’s high growth economies. As a result, the policy makers in many developing economies began adopting policies for more open trade during the 1980s. By the late 1980s nearly all of the centrally planned regimes that had followed restricted trade relations with other countries had introduced reform, which gave foreign trade and investment a prominent place in their development programme. These reforms led to dramatic changes in developing economies involvement in international trade.

Trade liberalisation is one of the prominent components of globalisation. Perhaps the most important aim of globalisation is the rapid integration of goods and financial markets, that is, promotion of trade and investment are the prime driving forces behind globalisation. Globalization is defined by International Monetary Fund as the growing economic interdependence of countries world wide through increasing volume and variety of cross border transaction in goods and services and of international capital flow and also through more rapid and widespread diffusion of technology. It is clear from the above definition that economic globalisation involves long distance flow of goods, services, capital and information. Globalisation also involves the organisation of the processes that are linked to these flows. Along this line, the distinguished economist, Paul
Krugman\(^1\) defines economic globalisation as the transfer of technology and capital from high-wage countries and the resulting growth of labour intensive exports in world exports. This definition stresses strictly on economic transactions and refers three critical components. These components are economic and financial flows, markets for the exchange of goods and services, and foreign direct investment via transnational enterprises. Friedman emphasised the role of free market, free trade and the free flow of capital in fostering economic integration while defining globalisation. Globalisation is therefore defined as a process whereby all national markets are integrated to form a global economic system where the production and distribution of products and services are made possible on a worldwide basis. Thus, the importance given to trade which has an important role in the economic growth of any country in reform agenda is very clear from the above definition.

Trade liberalisation is considered as one of the important components of globalisation process. This may be due to the fact that trade has a prominent role in the economic growth of any country. There exists a difference of opinion regarding the relationship of trade and economic growth and theoretical studies also show that the relationship between foreign trade and economic growth can be positive, negative or elective one. The classical and neo classical economists held the positive view. According to them foreign trade is an engine of growth. The classical theories of comparative advantage, Heckscher-Ohlin and Samuelson theories of factor price equalisation justify the virtue of free trade. The neo classical economic theory also argues that removal of trade barriers would improve economic welfare. On the other hand, structuralists believe that international trade has actually operated to the detriment of poor countries causing deterioration in terms of trade. In between the two, extreme positions lie the elective view, which incorporates some elements of these two schools.

Nurkse believes that growth in the underdeveloped countries should proceed through domestic industrialisation because there is little chance of reliance on export led growth. Nurkse further adds that the productivity in agricultural sector must also increase. Otherwise increased income from manufactures will be partly spent on foodstuff and thus create pressure on import or cause inflation. According to him, the strategic importance of export in economic development of an underdeveloped country is beyond any argument\(^2\).

Unlike the earlier theories, most of the new growth theories recognized the importance of trade openness. The new growth theories that emerged in the late 1980s provided a rigorous analytical framework within which trade liberalisation can be linked with economic growth. In particular, Grossman and Helpman (1992)\(^3\) argue that technological change can be influenced by a country’s openness to trade. According to him trade openness also provides access to imported inputs, which embody new technology and increases the size of the markets facing the producers which in turn raises returns to innovation and affects a country’s specialization in research intensive production. Thus a country’s openness leads to improvements in domestic technology, which helps the more efficient production process and culminates in productivity improvements. The new literature on endogenous growth links trade openness with innovation and growth.

Trade liberalization also enables cheaper and easier access to foreign technologies and global capital and makes possible greater international exchange of information. Lowering of trade restrictions makes possible the import of capital and intermediate goods which embody superior technology and this helps in reducing costs and also in turn increase productivity growth in the


sector which uses these products. Thus integration of the world economy will also influence the pace and direction of technical change positively.

Trade liberalization is also supported on the ground that it may help for correcting the domestic relative price ratio so that resources flow to the exportable sector whereas restricted trade regime leads to a resource misallocation by altering the domestic relative-price ratio in favor of the comparatively disadvantaged sector. Further, the lowering of controls on exports allows firms and industries to target the export markets and overcome under utilization of capacities due to deficient demand at home. The net result of this is to allow the producers to reap the benefits of scale and thus makes it possible to reduce costs. This is supposed to affect productivity growth positively.

The above arguments show that trade liberalization is supposed to have a positive impact on the economic growth and there by introduction of openness measures has gained an important place among different countries. Thus, there arose a need to organize and also to coordinate various activities related to trade liberalisation and for that various international organisations emerged. A brief account of the important international institutions that emerged to promote the trade openness as well as to coordinate the policies followed by different countries is given in the following section.

The most important international organization developed after the Second World War was General Agreement on Tariff and Trade (GATT). It was signed in 1947 by 23 countries. India was one of the founder members of the GATT. It was concerned with the promotion of international trade through tariff reduction, doing a way with non discriminatory practices and evolving rules to counter protectionism. The guiding principle of GATT is the Most Favoured Nation clause. GATT provided for the reduction in tariff and trade restriction in a phased manner over a period of time and this task is accomplished in different rounds of trade negotiations held from time to time. The first round was held in Havanna
in 1947. Eight rounds of multilateral trade negotiations were held and the eighth and last round was in Uruguay in 1986 known as 'Uruguay Round'.

Agriculture and textile and clothing have been brought with in the GATT fold in the Uruguay Round. The system of multilateral rules was extended to include Intellectual Property Rights and Services. The Uruguay Round did little to liberalise trade in agriculture and service. The three major areas with regard to market access for goods include liberalization of trade in manufactured goods, agriculture and textile and clothing. Both developed as well as developing countries have declared bound tariff on a large number of manufactured goods along with lowering of tariff rates. One of the major accomplishments of the Uruguay Round agreement is the Agreement on Textile and Clothing (ATC) which stipulates that the Multi Fiber Agreement (MFA) is to be phased out in three stages over a period of 10 years commencing January 1, 1995, which would integrate trade in textiles and clothing.

The signing of the final Act of the Uruguay Round by member nations of GATT in April 1994 paved the way for the setting up of the World Trade Organisation (WTO) and an agreement to this effect was signed by 104 members. The WTO agreement came into force from January 1, 1995 and India became a founder member of the World Trade Organisation. The main functions as set out in Article III are that the WTO shall facilitate and also provide the framework for the implementation, administration and operation of the agreement and of the Multilateral trade agreement. The second function is that WTO shall provide the forum for negotiation among its members concerning their multilateral trade relations in matters dealt with in the agreement. Another function is to administer the Trade Policy Review Mechanism. The administrative mechanism of WTO is divided into Ministerial Conference and General Council. The first Ministerial Conference was held in Singapore in 1996. The second conference was held in Geneva in 1998. The next Round was in
Seattle in 1999. The fifth WTO Ministerial Conference was held in Cancun, Mexico from September 10 to 14, 2003 and it was a mid term review of Doha development agenda, the fourth conference. The debate at Cancun was focused on two main issues like liberalization of agriculture and developing new multilateral discipline on the Singapore issue. These issues were raised by the developed countries in the first Ministerial Conference on the issue of investment, competition policy, government procurement and trade facilitation would merely be studied and that there were no negotiating mandates needed. This issue was opposed by the developing countries under the leadership of India and the developing countries succeeded in this attempt.

One of the key principles of WTO is nondiscrimination, i.e., any barriers to trade should apply equally to all member countries. There are four important exceptions to this vital principle. First, developed countries can give tariff preference to Less Developed Countries. Second, countries entering into regional free trade agreements do not need to extend the preference negotiated on an MFN basis. Third, countries can invoke a temporary safeguard protection to one of its industries suffering serious injury due to a surge of import. Fourth, temporary quantitative restrictions are allowed to deal with serious balance of payment problems. The ultimate objective of WTO is to remove all sorts of trade barriers, starting with tariff, to make free trade among all nations possible so that all markets are fully integrated and globalised and governments are obliged to accept unprecedented constraints on their autonomy.

Depending upon the major areas open for negotiation in the Uruguay Round, the WTO agreement can be divided into the following categories. (i) Agreement on agriculture, which provides the framework for long term reform of agriculture trade and domestic policies with the objectives of introducing, increased market orientation in agriculture trade. (ii) Agreement on trade in textiles and clothing (Multifiber Agreement). This provides for the phasing out
of the import quotas on textiles and clothing in force under the Multi Fiber Arrangement by the end of the transition period on January 1, 2005. (iii) Agreement on Market Access, in this the member nations will cut tariff on industrial and farm goods by an average of about 37 per cent. (iv) Agreement on Trade Related Investment Measures (TRIMS) calls for introducing national treatment of foreign investment and removal of Quantitative Restrictions. (v) Agreement on Trade Related Intellectual Property Rights (TRIPS). Prior to the TRIPS agreement, the intellectual property rights concerning the trade were governed by the Paris Convention of 1863, which was revised up to 1967. (vi) Agreement on services, the trade in services like banking, insurance, travel, maritime transportation, mobility of labour, etc. has been brought with in the negotiation and it is brought under the General Agreement on Trade in Services (GATS) rule.

These are some of the institutional arrangements developed for promoting the trade liberalisation efforts. Even then the efforts to liberalisation measures, reasons for its introduction, design of the reform package, benefits and its impact will be different for different countries. When, why, and how the reform process was carried out across the countries is explained below.

In most of the East Asian economies, trade liberalization efforts were made in the early 1980s. Reforms in South Asia were relatively slow and retained an anti-export bias. Taiwan was the first developing country to shift to outward orientation in the late 1950s by unifying and devaluing the exchange rate and adopting measures which gave exporters more or less free trade status. Korea followed Taiwan with a five-year lag and by 1985 she had removed most Quantitative Restriction (QRs) and tariff levels. Sri-Lanka is an exception in South Asia who replaced all QRs by 1977 and by mid 1980s there were no bans, import quotas and domestic content requirements. In Malaysia, Thailand and Indonesia, a situation of strong external payments created an impetus for trade reforms. In Philippines, the motivation for the reform came from the balance of
payments disturbances. India started providing easier access to imports as early as the late 1970s. However, major trade liberalisation attempts only occurred in the early 1990s. Turkey responded in the 1980s to the debt crisis by undertaking a stabilization program wherein reform of trade and payments policies was a key component. The character and pace of trade reforms differed from country to country reflecting differences across the Asian countries in the level of development.

The reasons for introduction of reforms varied among the different countries. It signaled a new phase of development for some countries (eg. China). For many countries, the reform measures were undertaken as part of macro economic stabilisation in response to economic crises faced by these countries (e.g. number of countries in Latin America and Africa). In launching these reforms, there was an active collaboration of the Bretton Wood institutions, i.e., International Monetary Fund and World Bank. The common element among all these countries has been the outstanding effort of their government in launching these reforms though they were not following the same mix of policies. The policy approach varied in different countries due to initial conditions for introduction of reform, potential political coalition, institutional capabilities, policy preferences and degree of international support. Due to these reasons the outcome and experience also varied among the countries.

In designing and sequencing reform it is important to consider whether trade liberalisation and stabilisation are compatible and whether the fiscal deficit and inflation should be reduced before trade policy reform is introduced. To the extent that tariff reduction leads to revenue losses, liberalisation can increase the deficit and lead to inflation (World Bank 1988)^4.

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Trade policy reform more than just reducing and streamlining border barriers, also requires developing institutions. Thus to take advantage of the opportunities created by open trade regime there is need for institutional capacity which is in short supply in developing economies. In addition, supporting policies are likely to be needed to alleviate adverse impact on particular group. Globalisation is likely to be sustainable only if it is accompanied by policies that equip people to take advantage of the benefits offered by increased integration with the rest of the world economy.\textsuperscript{5}

The benefits that derive from the trade openness also attracted the attention of the economists and policy makers and there also exists difference of opinion among them. Mostly the benefits of openness were analysed from two alternative perspective, first from the traditional trade theoretic viewpoint of the efficiency enhancing role of free trade in a static context and second from the perspective of growth accounting and inter-temporal efficiency and welfare. International trade economists have typically argued that an open trade regime is very important for economic development. This view has been based partly on neoclassical trade theory, which generally finds that a country improves its welfare from trade liberalisation, and partly on casual empirical observation, that countries which remains highly protected for long periods of time appear to suffer significantly.

The proponents of a neutral trade regime predict gains in manufacturing productivity from outward looking trade policies. Outward trade orientation brings about familiarity with new technologies, induces capacity utilization as well as scale benefits via production for export markets and brings about international competition. These in turn are expected to result in productivity improvements in the industrial sector. A number of theoretical arguments linking

trade liberalisation with higher rate of industrial productivity growth can be put down. These are (i) those that affect productivity growth via scale benefits arising from correcting the domestic-relative price ratio in favor of the comparatively advantaged sectors. (ii) Those, which help to improve productivity via the reduction in managerial slackness due to competition and (iii) those that allow imports embodying superior technology to improve productivity.

The openness also helps to reduce the barriers of trade. In general, when markets are functioning effectively, this will result in a reduction in the domestic price of the liberalized good, by either making cheaper foreign goods available or reducing the rents that may have previously been captured by domestic producers. It can also increase the production and can allocate the resources efficiently. Even if openness only refers to the goods market, liberalization allows improved access to the ideas and technologies embodied in foreign goods. Such access can, in principle, enhance a country’s technological capability and assist productivity improvement.

The main objections that have been raised against openness to international trade are; some sectors are dominated internationally by a relatively small number of large multinational enterprises. Many developing country governments fear that trade liberalization will enable large foreign companies to eliminate small domestic rivals through anti-competitive behaviour, even when those domestic companies are efficient. After domestic rivals have been removed, such companies could then be in a position to charge monopoly prices. Increased openness precludes the possibility of trade measures to protect strategic industries. Many East Asian economies used trade protection to stimulate investment and productivity improvements in industries with strong potential for technological capability. In the same way, as some commentators argue that capital market liberalization played a role in facilitating large and rapid capital outflows that precipitated the Asian crisis of 1997–98. It is said that
trade liberalization may increase terms-of-trade volatility and, as a consequence, the volatility of GDP. Furthermore, long-term changes in the structure of the economy resulting from trade liberalisation could increase the concentration of economic activity, making countries more vulnerable to changes in world prices. Several countries oppose participation in multi-country trade agreements (rather than openness itself) because of the loss of sovereignty involved.

Though trade liberalisation efforts are subjected to objection, most of the countries have recognized its importance as a means to promote the trade. Trade policy reforms launched by the developing countries, which form part of the privatization and liberalisation policies, aim to accelerate the economic development. This can be realised through improved international competitiveness, increased efficiency in the allocation of resources, stimulating domestic saving and investment and the strengthening of technological capabilities and exploiting dynamic comparative advantage. On the external sector, liberalisation consisted of measures such as reduction of export controls and state trading, the removal of import quotas, import licensing and other quantitative restrictions and reduction of the level and the variability of import tariff rate.

From the above discussion it is clear that the reasons for introduction of trade reform, objectives and policies followed by different countries were not similar. Various trade policy packages followed, its measurement and the main instruments used for measuring the impact of trade liberalisation by different countries are given below.

Trade policy relates to the overall structure of incentives to produce and consume and hence imports or exports tradeable goods and service. It typically serves the long run objective of growth and development. Trade policy is therefore usually closely linked to policies on both local and foreign investment, technology and particular sectoral objectives like industrial policy, agricultural
policy, regional policy, etc. In general, trade liberalisation has been equated with becoming more ‘outward oriented’. Liberal outward looking trade policies can lead to a higher economic growth through efficient industrialization of developing countries, only if they are accompanied by appropriate fiscal, monetary and exchange rate policies. The classical economist discussed the gains from trade in their work and advocated the policy of free trade. In his principles of Political Economy (1848), J.S.Mill discusses the gains that result from ‘Foreign Commerce’, which Mill further classifies into direct and indirect gains. The indirect gains from trade termed as ‘benefits of high order’ arise when a country which produces for a larger market than its own, can introduce a more extended division of labour, can make greater use of machinery, make use of more inventions and improvements in the process of production.

Pritchett (1996)\(^6\) argues that the term trade liberalisation tends to be interpreted in three broad ways. Countries may be considered more outward oriented if their trade reforms imply a move towards neutrality, liberality or openness. A move towards neutrality involves equating incentives, on an average, between the exporting and import competing sectors. A more liberal regime is one where the level of intervention has been reduced. Finally an increase in openness is equated with an increase in the importance of trade in the economy (as a percentage of GDP). Harrison (1996)\(^7\) suggests that a good measure of trade policy ought to capture the difference between neutral, inward oriented and export promoting regime.

The interaction between trade and commercial policies and macro economic policies is considerable and complex. Macro economic policies were related to the short term as well as long term achievement of overall internal and external balances.

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The two principle instruments of macro economic policy are aggregate demand (monetary and fiscal) policies and exchange rate policies. Trade and macroeconomic variables are strongly inter-related and interdependent.

Empirical measurements of the impact of trade policies have frequently been treated in terms of change in input or output mix rather than in terms of different policy regime. It is common to assume that there is a one to one relationship between output mix and policy, that is output mix actually revealed by policy. Obviously, there are many factors that influence upon output and output mix besides government policy. A simple measure of policy episode in different countries and time period is not easy to find out. The principal traditional summary measures of the orientation of trade policy and conceptually the simplest is that favoured by Bhagwati, Kruger and the World Bank-; the degree of anti export bias’ as measured by relationship between the exchange rate for a country’s export, allowing for all taxes and subsidies and that for its import. Trade interventions in developing countries are of two types, tariff and Non Tariff Barriers (NTB). Import tariffs are simply indirect taxes, which apply on a discriminatory basis, to imports. They may be ad valorem or specific. The range of instruments that qualify as non-tariff barrier is diverse, with some being fiscal, some quantitative, some involving monitoring and so on.

Direct price comparison and the coverage or frequency ratio of imports are used to measure non tariff barriers. Tariff barriers to trade are measured as either nominal or effective rate of protection. The tariff often used is either the published tariff rate or the collection rate, which is total import duty divided by the value of imports. The trade policy measurements based on black market premium is also used for measuring trade policy. Other important measures used for measuring trade policy are Trade Restrictiveness Index, Heritage Foundation Index, Index of Trade Liberalisation, Outward Orientation index, and Sachs-Warner openness index.
Thus it is clear from the discussion that the ultimate aim of trade liberalisation is the reduction of various restrictions on trade and thereby promotion of exports. More specifically trade reform comprises of policies and institutional framework to reduce the barriers of trade. It is also clear from the above explanation that trade reform has pros and cons on trade as well as on economic growth. In this study thus an attempt is made to examine the impact of trade liberalisation on exports from India.

Trade policies in India has undergone many changes since Independence and liberalisation has been a key ingredient of recent economic policies in India. Earlier, India like many other developing countries based her industrialization and development strategies on inward looking policy of import substitution. There has been a phase of inward looking import substitution strategy relying on high tariff and non-tariff barriers from the 1950s until around 1980s. There has been a gradual shift in policy since then and it changed into a structural adjustment programme in the 1990s. The dismantling of the high tariff barriers as well as changes in trade and industrial policies occurred during the period since 1990. This might have far reaching changes in the trade and trade related sectors of the country.