Chapter One

INTRODUCTION

India's constraint in foreign exchange reserves has become one of the major problems in India's economic development especially since the Second Five Year Plan. There have been signs in the Indian economy of a foreign exchange crisis owing to the increasing burden of debt servicing. According to the estimation of the World Bank report on India of 1983, the debt servicing ratio standing at about 9 per cent in the fiscal year 1982-83, is to rise to nearly 20 per cent in five years by 1987-88.

The prediction is based on the two important assumptions. Firstly, there will be a decline in growth of the flow of concessional loans which India has mainly relied on for foreign assistance. The net flow of such loans, which is considered to reach the peak in 1985-86, is expected to remain in the same level of Rs.1.8 thousand million in the subsequent years. The decline in availability of concessional loans is attributed to the prolonged recession in the aid-giving developed countries.

The report also takes into account the flow of non-concessional loans, such as institutional project-linked

1. Financial Express, "India Heading for Major Foreign Exchange Crisis" (New Delhi), 8 June 1983, p.1. The following figures on India's balance of payments are quoted from this article.
lending, that grows at 16 per cent per annum during the period of the five years. However, the impact of the decline in the non-concessional loan flow is not likely to be neutralised by it. It is estimated that the share of non-concessional loans in the net transfer will decrease from about 60 per cent in 1982-83 to 45 per cent by 1985. As for the uncovered gap in the requirements of foreign assistance by institutional loans, India has to go for borrowing on commercial terms.

Under such circumstances, commercial loans would be a more important content in India's foreign exchange assistance flow to India. Increasing reliance on commercial loans, however, is not a desirable phenomenon to India's economy. To cope with the problem in its balance of payments, it is imperative for India to take measures to accumulate foreign exchange reserves in the short run, along with the long run strategies to enhance the self-sufficiency in domestic finance resources by accelerating economic growth.\(^2\)

Foreign trade, as seen in the perspective of India's problem of balance of payments and economic growth, suggests a certain short run way-out, as exports are useful in raising foreign exchange reserves. Against its increasing significance in the Indian economy, it has been observed

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that India's share in the world trade declined over years (see Table 1.1). It indicates that India has not been able

to keep up with the pace of expansion of the world trade.

A similar trend is seen in India's trade with Japan. Japan made steady progress in India's foreign trade and has become one of its largest trade partners since the late 1960s among the countries like the United States of America (U.S.A.), the United Kingdom (U.K.) and the Union of Soviet Socialist Republics (U.S.S.R.) (see Table 1.2). India has not been able to keep up with the rapid expansion of Japan's foreign trade and its share in Japan's trade registered a decline in the early 1970s (see Table 1.3).

Table 1.1

<table>
<thead>
<tr>
<th>Year</th>
<th>Exports</th>
<th>Imports</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950</td>
<td>2.06</td>
<td>2.00</td>
</tr>
<tr>
<td>1955</td>
<td>1.36</td>
<td>1.38</td>
</tr>
<tr>
<td>1960</td>
<td>1.04</td>
<td>1.72</td>
</tr>
<tr>
<td>1965</td>
<td>0.90</td>
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<tr>
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<td>0.73</td>
<td>0.75</td>
</tr>
<tr>
<td>1973</td>
<td>0.57</td>
<td>0.61</td>
</tr>
</tbody>
</table>

### Table 1.2

India's Trade with Major Countries (% of total value)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1955</td>
<td>4.7</td>
<td>5.0</td>
<td>12.6</td>
<td>14.1</td>
<td>24.4</td>
<td>27.0</td>
<td>0.9</td>
<td>0.5</td>
</tr>
<tr>
<td>1960</td>
<td>5.5</td>
<td>5.5</td>
<td>19.6</td>
<td>15.7</td>
<td>20.1</td>
<td>26.4</td>
<td>1.4</td>
<td>4.5</td>
</tr>
<tr>
<td>1965</td>
<td>5.7</td>
<td>7.1</td>
<td>38.7</td>
<td>18.3</td>
<td>10.9</td>
<td>18.0</td>
<td>6.0</td>
<td>11.6</td>
</tr>
<tr>
<td>1970</td>
<td>12.8</td>
<td>13.9</td>
<td>28.6</td>
<td>13.5</td>
<td>6.3</td>
<td>11.6</td>
<td>7.8</td>
<td>13.4</td>
</tr>
<tr>
<td>1973</td>
<td>12.1</td>
<td>13.8</td>
<td>17.5</td>
<td>13.8</td>
<td>10.0</td>
<td>10.1</td>
<td>3.7</td>
<td>13.3</td>
</tr>
</tbody>
</table>

Source: Calculated from Appendices 1 and 2, pp. 348 and 349.

### Table 1.3

India's Share in Japan's Trade (% of total value)

<table>
<thead>
<tr>
<th>Year</th>
<th>India Exports</th>
<th>India Imports</th>
<th>India's Share in Japan's Trade with Asia Exports</th>
<th>India's Share in Japan's Trade with Asia Imports</th>
</tr>
</thead>
<tbody>
<tr>
<td>1955</td>
<td>4.2</td>
<td>3.1</td>
<td>10.0</td>
<td>8.5</td>
</tr>
<tr>
<td>1960</td>
<td>2.7</td>
<td>2.8</td>
<td>7.5</td>
<td>9.2</td>
</tr>
<tr>
<td>1965</td>
<td>2.4</td>
<td>2.3</td>
<td>7.4</td>
<td>6.9</td>
</tr>
<tr>
<td>1970</td>
<td>0.5</td>
<td>2.1</td>
<td>1.6</td>
<td>7.1</td>
</tr>
<tr>
<td>1973</td>
<td>0.9</td>
<td>1.5</td>
<td>2.9</td>
<td>4.2</td>
</tr>
</tbody>
</table>

Source: Calculated from Appendices 3 and 4, pp. 350 and 351.
It is proper to presume that as two of the important economic powers in Asia, the economic interaction through trade between India and Japan could have been more stronger. Japan, which had attained a miracle of the double-digit rate of economic growth in the 1960s, has been engaged in the 1970s in adjusting its industrial structure to make a smooth entry into the new era of industrialisation based on the knowledge-intensive technology. On the other hand, India, which is essentially an economy based on agriculture, accelerated industrialisation with its resource endowments since the Second Five Year Plan (1956-57 to 1961-62). It has been, at the same time, facing a problem of raising adequate resources for investment to sustain the economic growth.

The central issue of the bilateral trade expansion between India and Japan lies basically in India's capacity to promote exports to Japan. As Japan's capacity to export is highly sensitive to the demand of the world market while its import demand being large and diversified, expansion of the India-Japan trade is more or less upto India's initiative in expanding exports and changing the export structure to Japan.

1.2 Objectives and Scope of the Study

In this study, an attempt is made to identify the factors that have affected India's trade expansion and diversification with Japan and it suggests an alternative scenario of the India-Japan trade.

The specific objectives of the study are as follows:

1. To examine the economic complementarity existing between India and Japan;
2. To assess the importance of trade with Japan in India's economic development;
3. To examine the possibility of diversification of India's exports to Japan;
4. To identify the constraint that has limited the expansion of India's industrial exports to Japan;
5. To study the trade policies of India and Japan that have supported the horizontal specialisation of trade in manufactures between India and Japan.

The following sections outline more in detail the objectives and scope of the study.

1.2.1 Importance of International Trade in the Indian Economy

If the experience of the India-Japan trade is reviewed in the perspective of India's economic development, the trend in the bilateral trade between the two countries cannot be considered as desirable. The significance of
foreign trade to the Indian economy is outlined as an instrument not only for mobilising resources for development, but also for accelerating the pace of development by means of learning the technology implied in imports. Exports play a role as financing the requirements for development imported from abroad.

Primary commodities are those which a developing economy can provide for exporting at first. It is often argued that a high content of primary commodities in the export structure is an unfavourable factor to stabilisation and growth of the developing economy. Wide fluctuations in commodity prices make overall export earnings of the developing economy unstable. Moreover, the world demand for primary commodities is bound to shrink owing to their low income-elasticities and the development of synthetic substitutes.

The diversification of exports by expanding manufactured exports, therefore, has been of importance, as it brings to a developing economy increasing benefits. The policy of export promotion of manufactures is usually kept in line with the programme for industrialisation in developing economies, since expansion of manufactured exports has favourable effects on economic growth. It is useful in improving the resource allocation according to comparative advantage. The effects also include the improvement of efficiency by the effective exploitation of economies of scale and the greater specialisation in production.
1.2.2 Significance of the India-Japan Trade

An overview of the trend in the economies of India and Japan in the post-war period gives only a favourable picture for expansion and diversification of their bilateral trade. The Indian economy, which has been largely based on agriculture, intensified the process of industrialisation after the introduction of Five Year Plans. While the economy was almost subsistent and self-sufficient before the industrialisation was well under way, the external sector has become increasingly important in the process of development. As a major part of supply of the requirements for industrialisation, especially capital goods, have relied on imports, exports have been considered to be vital in accelerating the growth.

On the other hand, Japan developed into one of the important economic powers of the world in the post-war era, achieving high rates of economic growth. The traits of 'semi-backwardness' such as abundant labour supply and the existence of the traditional sector that survived the early stage of industrialisation in the pre-war period and the period subsequent to the war contributed a great deal to the economic growth since the late 1950s.

Japan's economic growth has been an internal as well as external phenomenon. The external sector of the economy has been playing a vital role in the development. Low self-
sufficiency in industrial materials and consistent updating of technology has oriented the Japanese economy to be highly dependent on imports. The production expansion has not been only towards the direction of internal consumption, but also towards the world markets. Thus, as Japan's economic growth after the late 1950s has been closely dependent on the international economic environment, it is natural to presume that the growth has had certain impact on the international economy too.

One of the important impacts of Japan's economic growth during the study period on the world economy is the transmission of the structural changes in the Japanese economy which has propagated the evolution of the international division of labour. Japan's economic growth has accompanied a drastic change in its economic structure and the emphasis of the Japanese economy moved into the manufacturing sector. The manufacturing sector has become the most important sector in the economy with regard to its magnitude in terms of national income and the role played in the transformation of the economy to promote a further change in its structure.

The structural change in the Japanese economy shifted its weight in the manufacturing sector from the light industrial, labour-intensive sector to the heavy and chemical industrial, capital-intensive sector. The change in the industrial structure was transmitted to the countries.
like South Korea, Taiwan and Southeast Asian countries, particularly through the medium of trade and joint ventures with Japan.

As the industrialisation made progress and the light industries gave way to the heavy and chemical industries with regard to productivity and the level of the production, Japan started to expand imports of the light industrial products which were insignificant in volume until then. The expansion of Japan's imports of light industrial products stimulated the development of the industries of the developing countries like South Korea. In these countries, with the policies directed to the light industries for protection and development and, in certain cases, with investment and technology transfer from Japan, the industries achieved high rates of growth in production and export.

The growth in imports of light industrial products received a greater impetus after Japan introduced the import liberalisation policy. It was in response to the growing demand from the world economy to harmonise its existence with the rest of the world. Particularly, the implementation of the Generalised Scheme of Preferences in 1971 on the suggestion from the United Nations Conference on Trade and Development (UNCTAD) provided a stimulus in expanding the imports of light manufactures from the developing countries.
Compared with the successful export performance of Far East and Southeast Asian countries, the export growth of the light industries from India to Japan has not been impressive. Several factors might have contributed to it, including such non-economic factors as geographical distance of India from Japan and the absence of strong political and social ties as Japan has with the other Asian nations. The endeavour in this study is to investigate the economic factors that have limited the export growth of India's light industrial products to Japan.

It can be said that the light industries of India and its competitor developing countries have been in the catching-up process of development, whereas Japan has been the technologically advanced innovating country. Although the level of industrialisation of light industries of India and its competitors is to be in the stage of export promotion, a distinction can be observed in their export performance in the Japanese market. The distinction is considered to be originated from the difference in competitiveness based on production efficiency of the industries of India and these countries.

1.2.3 Policy Approach for the India-Japan Trade

The problems in export promotion of India's light industrial products to the Japanese market are resulted from the constraints in the production structure and system of
India's manufacturing sector as a whole. The bottlenecks in India's export promotion of light industrial manufactures can be removed by increasing investment and improving efficiency. However, the problems can be effectively tackled only when the policy background exists in favour of export promotion of the industries. In this connection the policy background for India's export promotion of manufacturing including the policies directed to the two light industries is examined. The study also investigates Japan's trade policies, especially those which contributed to the bilateral trade between India and Japan, including the Generalised Scheme of Preferences introduced for the exports from developing countries. The policy background of India's light manufactured exports to Japan is assessed from the viewpoint of the harmonisation in conformity with India's efforts in the export expansion of the products. The discussion in this regard is mainly based on the results of various studies conducted so far.

The policy approach of Japan's trade with Far East and Southeast Asian countries that carries important implications to India's trade with Japan is the direct investment of the former to the latter countries. Direct investment brings benefits to the host country, for example, in the expansion of employment and domestic resources. Besides, transfers of technology and buy-back arrangements often accompany it, which are extremely useful in accelerating the
growth of the industry in the host country. One of the reasons behind the rapid expansion of manufactured exports to Japan from the countries like South Korea and Taiwan is the large investment undertaken by Japan to them. It can be concluded that more direct investment is necessary to be invited from Japan for expansion of India's manufactured exports to the country.

1.3 Methodology

The traditional theory of international trade is based on comparative advantage characterised with the relative abundance or scarcity of factors of production, assuming equality in quality of production factors and technology of different economies. Through the changes in comparative advantage and the terms of trade, the trading countries are supposed to derive the maximum welfare by achieving the general equilibrium.

The trend in the world economy since the 1960s showed limited relevance to the traditional theory of international trade. For example, the so-called 'transitional growth'4 that was experienced in the newly industrialised countries changed the traditional dichotomic

pattern of trade, viz., trade between primary-producing countries and manufacture-producing countries, into that among the continuous spectrum of countries, each in the process of catching-up and overtaking the other. The structure of comparative advantage in such a situation can only be explained by the composition of production and the 'quality' of productive factors. This version of comparative advantage is more useful in analysing the fierce competition in the world markets.\(^5\)

India's exports of manufactures to the Japanese market are also an example of the new development of international trade in the world economy. Japan, which is one of the innovating countries in the world, has initiated the expansion of imports of manufactures from developing countries. On the other hand, India, as one of the catching-up countries, having acquired technology for production of manufactures initially through the imports from innovating countries, started exports of manufactures to the industrial countries.

The study identifies the economic factors which have limited the export growth of India's light industrial products, with a help of the concept of the Ganko Keitai Growth developed

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by K. Akamatsu. The model formulates the process of the catching-up and overtaking in an industrial sector of a technologically less advanced country with advanced countries through trade. The entire growth process of the industry of the former is divided into four stages: import stage; import substitution stage; export expansion stage; and re-import stage. In the initial stage of import, the production technology is learned from the imports and the pressure of the domestic demand is created, which will give an impetus for setting up the domestic production in the next stage of import substitution.

If the industry succeeds to expand production to the level for export, it enters the third stage of the export promotion. The question whether the industry reaches this stage or not depends on how much the industry can expand production in excess to the consumption in domestic markets. The production expansion is feasible only when large investment is made to establish the economies of scale. However, as soon as the diminishing returns to scale start to operate, the production efficiency and eventually the level of production is affected. The last stage of re-import is reached when the product starts to be imported, so that the decline in the level of production is compensated.

The dynamism of the Ganko Keitai Growth lies in the production efficiency. The improvement of competitiveness in
the import substitution and the export expansion stages of
the Ganko Keitai Growth is a result of an increase in
production efficiency accompanying the production expansion,
which in turn gives an incentive to further expansion of
production and exports. Similarly, a decline in production
efficiency, when an industry passes the peak of expansion in
the transit from the export expansion stage to the re-import
stage, contributes to the fall in competitiveness of the
industry. The difference in the export performance of light
industries of India and its competitors in the Japanese market
can be interpreted as the difference in competitiveness of
the industries among them, arising from the gap in production
efficiency. In other words, while India's competitors in the
Japanese light industrial import market successfully passed
over the export promotion stage by expanding production, by
which further expansion was induced by the rising competitive-
ness, India's industries did not keep up with them as they
showed the limit to growth soon leaving the competitiveness
relatively stable.

The major task of this thesis is to investigate
the factors which prevented India to undertake diversification
of exports to Japan, notably expansion of light manufactured
exports, during the study period taken from 1951 to 1973.
Based on the proposition of the Ganko Keitai Growth, the
study constructs the hypothesis that the decline in produc-
tion efficiency affected the competitiveness of India's
light industrial products against the exports from its competitors in the Japanese market of other developing countries in Asia. The hypothesis is attempted to be proved by examining the trend in production efficiency of two of India's major light industrial exports to Japan, cotton fabrics and handtools, vis-a-vis those exported from South Korea, chosen among India's major competitors in the Japanese market.

The two light industrial exports are significant in India's manufactured exports to Japan, although they constitute only small proportions of the total value of India's exports to Japan, where more than two-thirds of it is comprised of two primary items, viz., iron ore and frozen shrimps. Cotton fabrics has been one of India's traditional exports along with jute manufactures and tea, while handtool is a major item of engineering products. These two exports are identified as important items in India's export promotion.

The production efficiency of an industry can be measured by the production cost of the product which the industry produces. However, measurement of the production efficiency by cost would not be feasible in this study owing to the specifications employed for the product and the classifications of manufactures adopted in the industrial statistics which vary from country to country.
An alternative way of measuring the production efficiency of an industry adopted in this study is the examination of the trend of the major components of the production efficiency of a product. By taking the major components of the production cost (short-run variable cost), that is, material input cost (n), wages (w) and depreciation cost (r), the production efficiency is based on the three components of the production cost, that is, efficiency-material cost \( \left( \frac{\partial}{\partial R} \right) \), efficiency-wages \( \left( \frac{\partial}{\partial L} \right) \) and efficiency-capital cost \( \left( \frac{\partial}{\partial K} \right) \), which are obtained by deflating material input cost, wages and depreciation cost by output-input ratio \( (O/R) \), labour productivity \( (O/L) \) and output-capital ratio \( (O/K) \). A rise or fall in the production efficiency factors contributes to the changes in the overall efficiency of the production.

Taking an example of cotton fabrics and handtools industries of India, Japan and South Korea, the study observes: (1) the changes in wage cost and material cost per unit of product, expressed in terms of index; (2) the changes in labour productivity and output-input ratio, expressed in terms of index; and (3) the changes combined those in (1) and (2) by deflating the former by the latter, viz., the changes in the efficiency-wages and the efficiency-material cost expressed in terms of index. The examination of the efficiency-capital cost is not undertaken in this study owing to the lack
of relevant data available and more significantly, its small share constituting (less than one per cent in case of India's cotton textile industry) in the total cost of production, of which changes may affect the least the overall production efficiency.

The period taken in this study for investigation is from 1951 to 1973. The year 1951 is significant in the history of the Indian economy as in that year India launched its First Five Year Plan. It is also important in the history of the Japanese economy as in that year Japan's national income restored to the pre-war level after the Second World War. The period ends in 1973 before the first oil crisis to avoid its effects on the trade between the two countries.

The data has been collected from different sources and it involves difficulty in adjustment on a uniform basis. Some of the sources consulted for the data in this study are listed here. For the statistics regarding foreign trade, Commodity Trade Statistics and Yearbook of International Trade of the United Nations have been referred, which are compiled uniformly by the Standard International Trade Classification (SITC). Some of the data particularly regarding

6. Detailed explanation on adjustment of each datum is found in the notes attached to Appendices 1-33, pp. 348-380.

7. The complete list of the statistical references in this study is presented in Bibliography, pp. 381-403.
India's and Japan's trade were collected from Monthly Statistics of Foreign Trade of India, Department of Commercial Intelligence and Statistics, Government of India and White Paper on International Trade, Japan External Trade Organisation, Ministry of International Trade and Industry of the Japanese Government, respectively.