ABSTRACT

There is uneven distribution of physical resources over the world. This has forced countries of the world to trade among themselves to fulfill their requirements. It is common therefore those countries voluntarily trade with one another because they gain from it. The gain comprises specialization on larger scale, greater output, lower prices of commodities and higher level of consumption than that under isolation. The actual distribution of this gains between the two trading partners, however, depends on the terms of trade or relative prices at which they exchange goods. If this exchange ratio is closer to the domestic exchange ratio of a country, the county gains less than that of other country and vice-versa. Further, if the terms of trade of a county improve over time, it enables the county to import a larger quantity of goods for same quantity of exports, or same quantity of imports for smaller quantity of exports. This raises national income of the country directly. It helps the country in raising national income indirectly too. The saving in exports for given quantity of import or additional imports obtained for the same exports can be utilized for development purposes. It is in this context, that the trend in terms of trade of a country has important implications for its development strategy.

Classical economists since the time of Adam Smith claimed that the terms of trade of primary commodity would rise over time as the limited availability of land and other natural resources would push their marginal costs and prices up. But this argument was challenged by Prebish and Singer first by claiming that terms of trade of primary products had fallen over time and second by advancing several reasons for downward trend and for expecting it to continue.
They based their belief of secular decline in terms of trade of developing nations on a 1949 United Nations Study that showed that the terms of trade of United Kingdom rose from 100 in 1870 to 170 in 1938. Since the U.K. exported manufactured goods and imported food and raw materials, while developing nation exported food and raw materials and imported manufactured goods, Prebish and Singer inferred from this that the terms of trade of developing countries (the inverse of the terms of trade of the U.K.) fell from 100 to 100/170=59.

The deterioration in commodity terms of trade of developing countries was attributed to differences in the modes of the price formation in the markets for primary commodities and those of manufactures, low income elasticity of demand for food etc. Because of surplus labour, large unemployment and weak or non existent labour union in most of the developing countries, the productivity gains in the production of goods and raw materials in these countries translated into lower production costs and lower prices of their exports. On the other hand, the relative scarcity of labour and strong labour unions in developed countries enabled labour in these countries to extract most of the productivity increases in form of higher wages, leaving cost of production and prices more or less unchanged. This difference in response to productivity increases in developed and developing countries enabled the former to have the best of both worlds. They retained the benefits of their own productivity increases in form of higher wages and income for the workers and at the same time they also reaped most of the benefits from the productivity increases taking place in developing nations through the prices that they were able to pay for the agricultural exports of developing countries.
The widening gap between prices of manufactures and primary commodities was also attributed to the fact that the income elasticity of demand for food is less than unity, and that technical progress in manufacturing tends to reduce the amount of raw materials used per unit of output. The protection of domestic primary production in industrialized countries further strengthened this tendency. On the other hand, the heavy dependence of developing countries on imports of manufactures, mainly capital goods, to attain faster economic growth and their simultaneous attempts to boost primary exports added to relative rise in the prices of manufactures. The collective terms of trade of developing countries deteriorated on a secular basis.

The assertion of Prebisch and Singer, though challenged on several grounds provided many of then less industrialized countries with a justification for import substitution industrialization during 1950s. The Prebisch-Singer hypothesis also generated a number of empirical studies testing whether or not the terms of trade of primary products had fallen.

Kindleberger in his study concluded that the terms of trade developing nations vis-à-vis Western Europe declined only slightly from 1870 to 1952. Lipsey in his study found that the terms of trade of developing nations in relation to those of the United States did not suffer any continuous downward trend from 1880 to 1960. They rose before World War I and from World War II to 1952 and declined since then. Spraos confirmed that the commodity terms of trade of developing nations had deteriorated from 1870 to 1938 but by much less than found in U.N. Study, after correcting for transportation costs and quality changes. By including the post-war period until 1970, however, he found no evidence of deterioration. In a World Bank Study, Grilli and Yang found that over the period 1900-1983 the terms of
trade of all primary commodities deteriorated at 0.5 percent per annum and 0.6 percent per annum for non-fuel commodities.

Bleaney and Greenway using a new and improved data series for primary product prices from the World Bank found a significant downward trend in terms of trade when data before 1925 were considered. But this was not the case in the period after 1925. They also noted that the prices for food, metals and other groups of primary products behaved differently. Many later studies have also come up with estimates of positive, negative and absent secular trends depending on time period explored, the definition used and the estimated techniques employed. Thus the terms of trade debate triggered by Prebisch and Singer in the early 1950s continues this day and remains unresolved.

Influenced by writings of Prebisch and Singer, India like many other developing countries also opted for the policy approach of industrialization through import substitution after gaining independence in August 1947. Imports were regulated both by quantitative restrictions and exceptionally high tariff rates. Tariffs also varied widely across sectors and commodities. The use of quantitative controls and licensing of imports became widespread. The tariffs and quotas taken together while promoted development of industries in the country discouraged competition, economic efficiency and expansion of exports.

The mid-1980s however, witnessed a marked change in India’s attitude and policy towards foreign trade. This change was initiated in 1985 when two official committees—one on trade policies headed by Abid Hussain and another on controls chaired by M. Narsimham recommended selected deregulation of controls on international trade and on controls in private investment. These recommendations were accepted and implemented in the
middle of 1980s. The change was intensified in mid-1991 when India faced
with problems such as insurmountable external debt, unmanageable balance
of payments situation, high possibility of acceleration in the rate of inflation
and unsustainable fiscal deficit introduced certain major policy reforms on
industrial, trade and public sector fronts along with measures of stabilization
for reduction in fiscal and current account deficits. The reforms introduced in
the trade sector included rationalization of exchange rate, liberalization of
imports, incentives to exporters and simplification of procedural formalities
and fostering of transparency. Since then the new trade regime has been
refined and tuned in many directions. The basic objective underlying these
changes in trade policy has been the creation of an environment for achieving
rapid increase in exports, raising India’s share in world exports, and making
exports an engine for achieving higher economic growth. The focuses of these
reforms have been on liberalization, openness, transparency and globalization
with a basic thrust on outward orientation.

The effect of these changes in the trade policy has been encouraging on
the volume, composition and direction of trade. India’s trade in value terms
has increased manifold over the reform period. The structure of trade has
undergone a significant change reflecting the changes that have taken place in
the Indian economy. Similarly the geographical pattern of India’s trade has
also witnessed some changes over the years. However, the critical question is
whether India has been able to increase her share in the gains from expanding
trade over the years. A sustained trend of improvement of the terms of trade
will mean the lower export cost of acquiring desired imports and increase in
real income and the country’s economic welfare. On the other hand, falling
terms of trade will indicate the increasing export cost of acquiring imports
and reduction in real income and domestic living standards. It is therefore,
essential that a study of the movement in India’s terms of trade is undertaken to know, the direction of country’s gains from trade over time.

Our objective in this study is primarily to analyse the course of movements in India’s terms of trade over the years 1985-86 to 2005-06 and assess its influence on the Indian economy. More precisely we suggest and test the hypothesis that a sustained trend of improvement in India’s terms of trade during the course of study has been missing and its influence on the economy has not been decisive.

The study is significant as India cannot remain indifferent to the course of movement in her terms of trade especially if the trends are fluctuating and largely deteriorating. A deteriorating terms of trade would mean a reduction in the magnitude of India’s gains from trade and a significant decrement to economic well-being over time. The policy makers would have to take additional measures to ensure that the size of gains from trade also rises with the level of trade.

The study is mainly based on secondary data, which include publications of various authors as well as the publications of the government. Other sources of data include publications of Economic Intelligence Service, Mumbai, the RBI and other sundry publications. Due acknowledgement has been given to them at appropriate places.

The methodology used in simple, analytical and involves simple calculations. As for the movements in terms of trade, we have relied mainly on three measures of terms of trade: gross, net and income terms of trade. This is mainly because these concepts are generally used in measuring the gains from international trade in empirical studies. The concepts of factorial and utility terms of trade are generally considered to be only of academic
interests and have little practical use. Their measurements require data which may not be available for any considerable period of time.

The study has as its period of reference the years from 1985-86 to 2005-06. The reasons for selecting this period are three fold. Firstly, this period has witnessed marked changes in India’s attitude and policy towards foreign trade. The effects of these changes, on the volume, compositions and direction of trade have been encouraging. Secondly, comparable data are available for this period. Thirdly, the period is sufficient enough to enable us to arrive at some broad conclusions.

The study has been planned into seven chapters including the present one. Chapter 2 is devoted to a brief review of the various concepts/measures of terms of trade and a short discussion of the movements in the terms of trade of developing countries over the period of study. Chapter 3 presents briefly the trends in India’s foreign trade over the period 1985-86 to 2005-06. This is followed by an analysis of the macro behaviour of India’s terms of trade in terms of Net Barter, Gross Barter and Income Terms of trade in Chapter 4, Chapter 5 deals with micro-behaviour of some of India’s trade items. The effects of the movements of terms of trade on Indian economy during the period of study are assessed in chapter 6. Finally chapter 7 presents the main conclusions of our study.

The main conclusions emerging out of this study are briefly summarized as under:

(i) India’s gross barter terms of trade which measures the volume index of imports as a ratio of volume index of exports remained favourable and above the base level during the period under consideration. But the pace of change was not steady. It fluctuated widely ranging between -2.4 percent and 17.1 percent. Further the improvement in gross barter terms of trade was
dominated by the growth in import quantum index which increased from 182.3 in 1985-86 to 1649 in 2005-06. During the same period the export quantum index increased from 111.3 to 1005.

(ii) The net barter terms of trade which measures the unit value index of exports as a proportion of unit value index of imports also behaved favourably during the period under study. But this favourable development was also not equally spread over the whole period. India’s net barter terms of trade improved at the rate of 0.8 per annum during 1985-91. It accelerated to 2.8 percent per annum during 1991-97. But the acceleration could not be sustained. The rate of growth decelerated to 0.2 percent per annum in 1997-02. It however, picked up again to 2.7 percent per annum during 2002-06.

(iii) The increase in income terms of trade reflecting capacity to import experienced a relatively stable and consistent improvement. But this was not due to the improvements in net barter terms of trade. It was expansion in export quantum that pulled up income terms of trade in most of the years and on a consistent basis. The growth in quantum index of exports was a negative figure at -2.2 percent per annum during 1997-02 against a positive growth in net barter terms of trade at 0.2 percent per annum during the same period. But this was largely due to a steep decline in export quantum index in 1997-98.

(iv) Group-wise, the gross and net barter terms of trade of food and food articles deteriorated sharply and turned negative in 1991-92, 1995-96 and 2001-02. For beverages and tobacco, the gross barter terms of trade was favourable while the net and income terms of trade remained negative and below the base level in most of the years. In the case of mineral fuels and lubricants, the gross barter terms of trade deteriorated over the period of study excepting the years 1998-99 and 1999-2000. The net barter terms of trade
was largely unfavourable in the pre-reform period and turned favourable in post-reform period. The income terms of trade registered an increasing trend during the period under consideration.

The gross barter terms of trade of manufactured goods was favourable for India in the pre-reform period but turned against in eight out of 15 years in the post-reform period. The net barter terms of trade remained largely favourable except four years in which it turned negative. The income terms of trade of manufactured goods improved and registered rising trend during the period of study.

Machinery and transport equipment largely called as engineering goods experienced favourable movement in all the three measures of terms of trade.

For chemicals and allied products the gross barter terms of trade worsened and remained below the base level excepting the years 1985-86 and 1987-88. The net barter terms of trade were adverse in 12 out of 21 years under review. The income terms of trade improved consistently.

(v) Fluctuations in terms of trade implied limited participation of India in the share of gains from trade. The terms of trade failed to influence the course of movement in India’s balance of trade and the relationship between the two remained largely negative in majority of the years under review. Further, as the gains from trade are surplus which can be used for investment, deterioration in terms of trade implied lesser quantum available for investment. The pace of development could not receive the essential support from trade.

Furthermore, a greater degree of fluctuations in the movement of unit value index of exports than the fluctuations experienced in the unit value
index of imports or deterioration in net barter terms of trade had detrimental effects on foreign exchange resources. India lost 'potential' foreign exchange earnings because of relatively higher import prices.

Thus the basic contention that emerges from this study is that the fluctuations in India’s terms of trade through its various effects on balance of trade, domestic prices, economic development and foreign exchange resources and distribution of global gains from trade worked as a constraint on her economic development. Our conclusion broadly supports the Prebisch-Singer doctrine.

The study suggests that in the interest of economic development, we should try to reduce the constraints imposed by fluctuations in India’s terms of trade. The solution to the problem of adverse net barter terms of trade is to restructure the distributional pattern of productive resources from sectors where the foreign exchange realization per unit is declining or susceptible to large fluctuations to those where the unit value realization is increasing. The solution to improve the income terms of trade is a high growth rate in export quantum. These objectives can be achieved with the help of:

A. Policy of price stabilization;
B. Increase in the price elasticity of export supplies;
C. Diversification of exports towards commodities of higher value;
D. Diversification of markets;
E. Transfer of appropriate technology; and
F. Improvements in the existing international trading system.