Chapter - I

Introduction

1.1 The Problem:

It is a common knowledge that 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 country gains less than that of other country and vice-versa. Further, if the terms of trade of a county improves over time, it enables the county to import a larger quantity of goods for same quantity of exports, or same quantity of goods 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 trends in terms of trade of a country has important implications for its development strategy.
The significance of terms of trade concept has long been recognized in the context of international trade theory. 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. (Dia Kosvvas and Scandizzo, 1991). But this argument was challenged by Prebish (1950) and Singer (1950), 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 (Singer-1950, p. 311) 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 the 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. (Singer 1950:312). 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 Prebish and Singer, though challenged on several
grounds (Salvatore 1990:320), provided many of then less industrialized
countries with a justification for import substitution industrialization
during 1950s. The Prebish-Singer hypothesis also generated a number
of empirical studies testing whether or not the terms of trade of primary
products had fallen.

Kindleberger (1956) in his study concluded that the terms of trade
developing nations vis-à-vis Western Europe declined only slightly
from 1870 to 1952. Lipsey (1963) 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 (1983) 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 (1988) 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 (1993) using a new and improved data series for primary product prices from the World Bank (Grilli and Yang, 1988) 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. (Hadass and Williamson, 2001). Thus the terms of trade debate triggered by Prebish and Singer in the early 1950s continues this day and remains unresolved.

Influenced by writings of Prebish 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. (Mathur, Vibha, 2006) This change was initiated in 1985 when two official committees-one on trade policies headed by Abid Hussain (GoI-MoC 1985) and another on controls chaired by M. Narsimham (GoI-MoF)-recommended selected deregulation of controls on international trade and on controls in private investment (Tendulkar and Sen, 2003). 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
(Sharan and Mukherje 2001). 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 focus of these reforms have been on liberalization,
openness, transparency and globalization with a basic thrust on
outward orientation. (GoI, 2001-02)

The effect of these changes in the trade policy has been
encouraging on the volume, composition and direction of trade.
(Chapter -3). 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, a 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.

1.2. Objectives of the Study:

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.
1.3. **Data and Methodology:**

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 is 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 factoral 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.

1.4. Plan of the Study:

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.

References:


4. Ibid.

5. Ibid.


17. For detail see chapter 3