ECONOMIC REFORMS AND ITS IMPACT ON EXTERNAL SECTOR IN INDIA

ABSTRACT

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ABSTRACT

This study focuses on the economic reforms and its impact on external sector in India. The study shows that during the past two decades, India has experienced wide ranging reforms in the various sectors of the economy. These reforms were initiated in July 1991 when an economic crisis of unprecedented severity surfaced in the country in the form of high inflation, rising food prices, large current account deficit, huge domestic and foreign debt, a sharp fall in foreign exchange reserves, a steep decline in India’s credit rating, and a cut off of commercial loans accompanied by a net outflow of Non-Resident Indian (NRI) deposits.

The crisis was the outcome of the long-term constraints of the preceding four decades, especially the 1980s and certain immediate factors. After achieving independence from British rule in 1947, India pursued policies that sought to assert government planning in most sectors of the economy and promote self-sufficiency. This was essentially a reaction to the colonial regime’s laissez faire and free trade policy that was identified as the basic cause of India’s economic underdevelopment by the pre-independence political leadership. These policies achieved some economic goals (such as rapid industrialisation) but the overall effect was to promote widespread inefficiency throughout the economy. The strategy of import substituting industrialisation made the Indian industry inefficient and technologically backward due to the absence of competition. Discouragement of foreign capital compounded this problem. Private sector was heavily regulated through the system of licenses and permits. This caused a great damage to entrepreneurship and innovation. Public sector dominated this strategy but became highly inefficient and even sick due to the excessive political interference. Emphasis on self sufficiency led to export pessimism.
Imports, on the other hand, could not be contained as they consisted of essential goods and key inputs which were very much needed for accelerating the pace of industrialisation. As a result, imports ran ahead of exports and the country experienced a continuous trade deficit with the exception of two years 1972-73 and 1976-77 when there were some surpluses on this account. The fiscal situation deteriorated through the 1980s due to the populist policies pursued by the government, rapid growth of state controls over the economy and reservation of certain areas for small scale industries.

However, the immediate factors which triggered this crisis were the Gulf War of 1990, and the collapse of the Eastern Block. The Gulf War led to the surge in India’s oil import bill and cessation of exports to Iraq due to UN trade embargo on that country. Repatriation of workers from Kuwait ceased their remittances and led to foreign exchange expenditure on transporting Indians from the affected countries in the Middle East. The collapse of Eastern block – India’s major trading partner at that time – further aggravated the balance of payments crisis.

The government tried to overcome this crisis by borrowing from the IMF but did not succeed. The country’s foreign exchange assets dipped from US $ 3.4 billion at the end of March 1990 to a low of US $ 975 million on July 12, 1991. This was equivalent to barely a week’s imports. The country was on the brink of default in the discharge of its international debt obligations.

The economic crisis led India to introduce reform in economic policies. The decision was also influenced by the experiences of spectacular growth of East Asian Economies of South Korea, Taiwan, Singapore and Hong Kong in 70s and 80s following the introduction of economic reforms in 1950s and 1960s and also that of China which introduced reforms in 1978. The reforms in the economic policies
consisted of two basic sets of measures. The first set aimed at achieving macroeconomic stabilization by reducing both fiscal and balance of payments deficits. Reduction in fiscal deficit was sought to be achieved through cut in public expenditure and increase in public revenue. To reduce the balance of payments deficits, the reform programme heavily relied on currency devaluation to boost exports and reduce imports.

The second set of measures were directed towards altering the production structure by increasing the role of the markets in the economy directly through privatization or by way of reduction in state investments and interventions and indirectly through domestic deregulation and by trade liberalization. The structural reform measures encompassed liberalization of trade and investment policies with emphasis on exports, FDI and reduction in external debt, industrial deregulation disinvestment and public sector reforms and reform of the capital markets and the financial sector.

The reforms were introduced with a view to provide a new dynamism to the economy by improving the overall productivity, competitiveness and efficiency. Over the past two decades since 1991, the reform measures were intensified and extended in many directions.

Objective of the Study

In the above background and also in recognition of the growing importance of the external sector in Indian economy, this study has been undertaken primarily to assess the impact of economic reforms on the external sector of India.

Further as within the external sector the main focus of economic reforms has been on expansion of trade, capital inflows and reduction in external debt burden, the specific objectives set out for the study are:
(i) To provide insight into the reforms that have been introduced in India in the field of foreign trade, foreign direct investment and external debt since 1991.

(ii) To examine the impact of these reform measures on trade, foreign direct investment and the external debt.

(iii) To identify factors that constrains India’s performance in these fields.

(iv) To suggest policy measures which should be taken to improve competitiveness of exports, overall investment climate and reduce external debt burden in the long run.

**Hypotheses of the Study:**

The study tests the following hypotheses:

1) The impact of economic reform policy package on India’s external sector has been broadly positive.

2) Reforms have improved India’s trade performance significantly in the post-reform period compared to that of pre-reform period.

3) External sector reforms have led to the acceleration in FDI inflows to India during the post-reform period.

4) India’s external debt position in the post-reform period has improved considerably following the introduction of policy reforms in managing the debt.

**Database and Methodology**

The study is based on the time series secondary data collected from publications of various authors as well as the publications of the government agencies. Due acknowledgement has been given to them at appropriate places.
Though the study has as its period of reference the years after 1991, but to assess the impact of economic reforms on the external sector, we have examined the performance of external sector during 1992-2010 (post-reform period) and then compared the same with performance during 1980-1991 (pre-reform period). The year 1991-1992 is excluded from the analysis due to the economic crisis of 1991 and abrupt changes in 1991-1992. The post-reform period is further sub-divided into two sub-periods covering the decade of the 90s and the first decade of the 21st century to examine the impact of reforms more intensively.

The methodology used is simple and analytical and does not go beyond calculations of percentages, arithmetical averages, year to year, and trend rates of growth. Yearly growth rates are computed as under:

\[
G_t = \frac{Y_t - Y_{t-1}}{Y_{t-1}} \times 100
\]

Where,

\(G_t\) = Growth rate for period \(t\)

\(Y_t\) = Value of the variable in period \(t\)

\(Y_{t-1}\) = Value of the variable in period \(t-1\)

The trend rate of growth has been worked out by estimating the function:

\[
Y = AB^t
\]

\[
\log Y_i = \log a + t \log (b_i)
\]

Where,

\(Y\) = Value of Exports / Imports

\(t\) = Time variable

\(B\) = Growth rate or \((B-1) \times 100\)
The significance of the growth rates has been tested by applying t-test and estimating $R^2$.

**Plan of the Study**

The study is organized in seven chapters. The first chapter deals with the problem under investigation, objectives of the study, data sources, methodology and plan of the study. Chapter 2 is devoted to a brief review of existing literature in the field. Chapter 3 provides an overview of key reforms that have been introduced in the Indian economy since 1991. Chapters 4 to 6 are devoted to the appraisal of reform processes on foreign trade, foreign direct investment and external debt respectively. Finally, Chapter 7 summarizes the study, highlights the important findings and offers policy suggestions to improve external sector on a sustained basis.

**Main Findings of the Study**

The study reveals that the impact of economic reform policy package on India’s foreign trade sector, foreign direct investment, and external debt has been broadly encouraging. Thus, the hypotheses set out in Chapter 1 have been proved true.

Chapter 4 assesses the impact of economic reforms on the foreign trade sector. It analyses the growth in India’s exports, imports and balance of trade over the period 1980-81 to 2009-10. The analysis shows that:

- Following the introduction of reforms, the foreign trade scenario in India has undergone considerable change and there has been sizeable increase in the value of both exports and imports.

- Over the years 1980-81 to 1990-91, India’s exports increased by 2.14 times rising from $8486 million to $18143 million. The post-reform years witnessed
a surge in exports, when they increased by 9.6 times and rose from $18537 million in 1992-93 to $178751 million in 2009-10.

On an average annual basis, the growth in India's exports during the post-reform period at 14 percent was significantly higher than that of 8 percent registered during the pre-reform period.

- Within the reform period exports increased by 11 percent per annum during the first decade of reform (1992-93 to 2000-01) and accelerated to 17 percent per annum in the decade of the new millennium (2001-02 to 2009-10).

- The trend rate of growth in exports in the post-reform period at 9.3 percent per annum was significant and higher than that of 7.4 percent registered in the pre-reform period.

- The post-reform years also registered a surge in imports when they increased by 13.18 times compared to that of 1.5 times in the pre-reform period. The average import growth during the post-reform years at 17 percent per annum was more than double of that recorded in the pre-reform period (8 percent). Imports increased at 12 percent per annum during the period 1992-93 to 2000-01 and picked up to 22 percent per annum in the period 2001-02 to 2009-10.

- The growth in India's exports during the post-reform period failed to keep pace with the growth in imports and the trade deficit continued to plague the economy.

- India's exports over the period 1980-2008 grew at a faster rate than that of world exports. But the difference was more marked in the post-reform period. World exports in the period 1980-1990 increased at a compound growth rate of
6.1 percent per annum while the corresponding rate of growth for India’s exports was 7.0 percent. In the post-reform period (1992-2008) the annual average export growth in India’s exports at 12.8 percent turned out to be still higher than 8.4 percent in the case of world exports. Consequently, the limited share of India’s exports in world exports (around 0.5 percent) in the pre-reform period improved considerably in the post-reform period and reached to the level of 1.11 percent in 2008 indicating rising penetration of India’s exports in the global market.

❖ The ratio of India’s merchandise exports to GDP was 5.28 percent in the pre-reform period. It nearly doubled in the post-reform period reaching the level of 10.25 percent. Imports as a proportion of GDP increased from an average of 8.67 percent during the pre-reform period to 14.37 percent during the post-reform period. This represented both the contribution of trade to national income and the degree of openness of the Indian economy.

❖ Though the contribution of exports in financing imports was greater during the post-reform period, the goal of self balancing of trade remained unfulfilled.

❖ Product-wise analysis of growth of India’s exports reveals that there was a wide variation in the pattern of growth of major exports and as a result their shares in total exports changed over the reform period.

❖ Some diversification in India’s exports by destination also took place during the post-reform period. The most significant change in the destination structure of India’s exports during the post-reform period was the sharp decline in the relative share of the Eastern Europe in the country’s total exports. On the other
hand, OPEC and Developing Countries took a big leap forward and more than compensated the losses suffered in the Eastern Europe market.

Chapter 5 is devoted to the study of FDI inflows in India in post-reform period.

- The study reveals that net FDI inflows to India remained at $0.12 billion during the pre-reform period on an annual average basis. This amount surged manifolds to $10.30 billion in the post-reform period. However, the surge was not steady. It remained at $2.05 billion during the first decade of external sector reforms and jumped to $17.74 billion in the second decade.

- In early years of economic reforms there was a huge gap between approved FDI and actual FDI inflows in India perhaps due to fear from foreign capital and criticism from many beaureucrats, etc. The realisation rate was quite high at 70.01 percent in 1991 which significantly decelerated to 18.1 percent in 1992 and 21.01 percent in 1993. This trend reversed from 1998 when realisation rate increased to 48.1 percent, slightly reduced to 40.4 percent in 1999 but since 2000 it kept on increasing with 71.67 percent in 2000, 214.47 percent in 2003 and 218.91 percent in 2006. During the period of reform, the realisation of FDI inflows in India was 72.35 percent.

- The FDI in India during the post-reform period was mainly in the services sector. Further there was a significant change in the direction of FDI inflows. During the first decade of reform US turned out to be the largest direct investor for India while in the second decade Mauritius topped the list.

- There was also a significant change in the routes through which FDI inflows came in the Indian economy. At the time of economic reforms there were only two routes: Government approvals (through FIPB, SIA) and RBI's various NR.
schemes. The total FDI inflow in 1991 was Rs.3535 million of which major part came through the route of RBI's various NRI schemes. However, in order to facilitate speedy inflows of FDI into India automatic approval route was introduced in 1992. This route witnessed large inflows and surpassed the FDI inflows through RBI's various schemes in 1998. Since then it kept on rising. However, the largest quantum of FDI inflows took place through the route-government approval (through FIPB, SIA) till 2003. Post 2003 FDI inflows through automatic approval turned out to be the major source of FDI except for year 2005. After 2003, RBI's various NRI schemes as a separate channel was abolished and it was merged under the heading RBI automatic approval route. Therefore, RBI automatic approval route turned out to be the largest FDI generator in post 2003 period.

There was an increase in number of technical and financial collaborations in post-reform period. The main motive of the liberal FDI policies was to bring in more technical collaboration in order to raise domestic productivity. However, it was the financial collaborations that surpassed the technical collaborations. There were two factors responsible for it: first, the liberal investment opportunities in India, and secondly lack of any attractive proposals for technical collaboration that led to the rise in financial collaborations.

India's share in global FDI inflows increased steadily under the post-reform period. India ranked 8th among top FDI recipients in the world in 2009-2010. It is however, important to note that the surge looks impressive only in isolation. Comparative figures place India at a very low position. In the years 2009 and 2010, the size of FDI inflows to India stood at $35.65 billion and $24.64 billion.
billion respectively as opposed to $114.21 billion and $185.08 billion in China during the same period. Thus, what India received during these two years was not even half of what was received by China. This means that economic reforms in India have still a long way to go to attract FDI inflows into the country.

Chapter 6 analyses the impact of reforms on external debt in post-reform period.

❖ The main reason for the accumulation of perilous external debt in 1991 was the Asiad which were organised in infrastructure scarce economy like India. In order to make particularly Delhi a perfect place for games gigantic expenditures were made. This amount could have been used up latter for economically productive purposes for which in latter eighties borrowings were made. However, in post-reform period India's external debt policies underwent a radical shift. External debt remained under control due to prudent debt management throughout post-reform period. The external debt policies introduced in July 1991 had a positive impact on India’s external debt position as the annual average growth rate of India’s external debt more than halved to 6.56 percent per annum in post-reform period as compared to 13.75 percent in pre-reform period.

❖ The share of short term debt in total external debt declined from 9.55 percent in pre-reform period to 7.84 percent in post-reform period. However, within the reform period, the share of short term debt tended to increase from 2001-02 particularly after 2006-07. While long term debt on the average constituted a little more than 90 percent of India’s external debt in the pre-reform period, this share increased marginally to a little over 92 percent in the reform period. The long term debt was mainly dominated by the multilateral debt, commercial
borrowings, bilateral debt and NRI deposits which constituted at around 87 percent total external debt.

❖ In case of borrower classification, the share of government debt in total debt declined significantly due to the decline in the rupee denominated debt and the IMF debt and the rising role of private sector and Indian corporate during the reform period.

❖ However, the debt servicing burden increased significantly in second decade of reform due to increase in commercial borrowings. India's debt service payments had a fluctuating trend during the reform period. It increased at the rate of 3.88 percent per annum during the period 1990-91 to 2000-01 and jumped to the level of 14.23 per annum during 2001-02 to 2009-10. For the reform period as a whole the growth rate was 8.53 percent per annum.

The external debt sustainability indicator improved substantially. However, the ratio of short term debt to total debt increased along with a reduction in the ratio of concessional debt to total debt thereby, creating concern.

Conclusions and Policy Implications

Some important conclusions of the study may be listed as follows:

Foreign Trade

❖ There has been a marked change in the perception of the government of India and its policy makers in the past two decades towards the role of trade in the strategy of the development of the country. Exports have come to be regarded not merely as a source of financing imports but also as means of efficiently
allocating resources. Accordingly trade policy of pre-liberalization phase which discouraged exports and fostered high cost imports substitution has been replaced to a greater extent by an open trade regime. The basic thrust of this regime has been on globalisation of Indian economy, improving its competitiveness and expansion of exports to ease pressure on balance of payments.

India's trade performance has shown a considerable improvement during the post-reform period. It has improved in size, composition and the direction, compared to the pre-reform period. However, the extent of India's penetration in the global market has been limited at the aggregate level. The commodity wise picture also shows that only a limited number of commodities have been able to register an upward move in their share in world exports. This can be attributed to both external and domestic factors. Externally, India's exports continue to face the problem of adverse world trading environment, protectionist policy of the developed nations and their tariff discrimination. Among the domestic factors that hamper India's exports are infrastructural constraints, high transaction costs, poor quality, limited FDI in the export sector etc. An effective export strategy will have to keep these factors into account for future expansion in exports.

FDI

Liberalisation of the FDI policy regime has resulted in a substantial expansion of FDI inflows to India during the post-reform period both in absolute and relative terms. The surge, however, was impressive only in isolation. Comparative figures placed India at a very low position.
The major deterants to the FDI inflows to India included lack of global competitiveness of the Indian economy, tough business environment, low purchasing power, poor infrastructural facilities, rising inflation and political instability.

India’s efforts to attract relatively higher levels of FDI in the years ahead will depend on the adoption of a more purposeful and pragmatic approach towards this source of foreign capital. India has great potential in terms of natural resources, labour availability and intellectual capital. We have a modern financial system, a large domestic market, a large educated middle class, capacity to absorb modern technology, marketing and managerial skills. The capacity to absorb larger FDI inflows is thus, manifestly present. What is needed for the full realization of this potential is a special drive to overcome the difficulties enumerated above and create a more competitive environment – “a level playing field” in the economy.

External Debt

India has also experienced a perceptible improvement in external indebtedness position since 1991 on account of a conscious debt management policy focussing on high growth of current receipts keeping the maturity structure as well as the total amount of commercial debt under manageable limits, tight monitoring of short term debt and encouragement to non-debt creating inflows. Such international debt management policy should continue in the years to come.

The post-reform period also witnessed some shift in the structure of external debt. The contribution of long term debt in the total debt improved marginally.
while the share of short term debt had gone down. However, it is important to note that the share of short term debt had a tendency to rise in the second decade of the reform period. This calls for further reform measures to keep the share of short term debt low.

❖ Another important change in the structure of India’s external debt during the period of study was the dominant share of government debt in the total debt during the first decade of reform and that of non-government debt in the second decade of reforms. This could be attributed to rising private sector activities and the steep rise in FDI post 2004 period.

❖ India was able to keep external debt service payment under control which in turn led to the sustainability of debt. India performed well among top indebted developing countries.

Policy Implications:

Following policy implications are derived from the findings and conclusions of the study:

a) Foreign Trade

❖ Efforts should be made to change the composition of India’s exports by making it more dependent on manufacturing sector.

❖ There is an urgent need to raise per capita output in export sector in order to raise productivity along with measures to reduce cost of production. This will make exports more competitive in international market. In current scenario of
inflationary pressures in Indian economy this task seems to be quite hard to find.

❖ Efforts should be made to encourage FDI inflows in the exports sector to raise its productivity.

❖ India's exports should be more directed towards developing and newly emerging economies in order to have sustainability in India's export growth even at times of global economic crisis. The exports should not be dependent much on developed world because they are now more prone to global economic crisis.

❖ There should be strict regulations regarding 'composition of exports baskets' in India. In recent years without assessing the domestic demand for goods, government had exported items in order to raise export income. This led to shortage of supply of essential particularly food items in India leading to inflationary pressures.

❖ Government should make efforts to increase the intensity of competition in domestic industries, in order to increase competitiveness and hence raise quality and quantity of production.

❖ Government must implement an effective exports strategy that could overcome various internal and external constraints that hampers required export growth.

b) FDI

❖ There has been a marked increase in the magnitude of FDI inflows to India during the post-reform period reflecting the liberal policy regime and growing
investor's confidence. The policy has however, lacked political commitment, coherence and direction. As a result India has not been able to realise its full potential in the field of FDI. The inflows of FDI to India during the post-reform period pales into insignificance compared to inflows to China. The FDI policy and implementation strategy need to be fine tuned with a view to attract high quality FDI for taping comparative advantage in the labour intensive manufactures.

- There is a need for political commitment and objective clarity at the highest level to ensure that FDI flows are diverted as per national priorities.

- There is a need to change the direction of inflows of FDI, because Mauritius can no more be considered as a dependent source of FDI inflows in long term. India will have to pay a high cost if Mauritius government bring a slight change its direct investment policies.

- India should control its inflationary tendencies. Inflation raises cost of production thereby; makes Indian exports less competitive in international market, and also discourages direct investors spirit. Further due to increase expenditure levels, inflation raises chances of widening external debt.

- Strict laws should be made to reduce corruption levels. India has witnessed multiple corruptions/scams in the past few years which lower confidence of foreign direct investors on dependability of Indian authorities. This does not permit them to bring huge investments in India.

- India should develop infrastructural set up particularly the distribution of power, transport and road networks in different parts of the country, in order to increase the frequency of foreign direct investments inflows.
Foreign direct investments should be equally distributed throughout India. Currently there exists regional inequality in case of location of FDI inflows. Most of the FDI are directed in selected rich states mostly, southern states while northern India is deprived of required FDI except for few regions. Therefore, the benefits of FDI remains confined to certain selected states.

FDI should be encouraged in agricultural sector which is the most badly affected sector in post-reform period. The government must provide incentives to direct investors in order to revive this sector. Today, when India is facing severe inflation problem, an increase in production and productivity of agricultural sector is likely to help in reducing inflationary tendencies in agricultural and allied goods. FDI will bring new technology, methods of production, etc in which India is deficient since independence.

Government should try to avoid delays in approval of several large FDI projects.

‘Green Politics’ in India also discourages direct investors to invest in India. It should be strictly avoided. POSCO case in recent years created a lot of chaos at international level.

There is a need to create more liberal labour laws.

Government should try to make Special Economic Zone policies more active and constructive.

There is a need to increase centre-state coordination in order to have much better results from FDI.
c) **External Debt**

- Independent organisation should be set up in order to carefully examine the use of external debt in India. In other words, how much of external debt is used for economically productive purposes and how much is directed for non-productive purposes, should be strictly regulated by the organisation.

- An important element which raises external debt is increase in global prices of oil. India should try to increase domestic production of oil in order to reduce import bill. This could be achieved by providing incentives to domestic producers and foreign direct investors to invest in this sector. India’s second largest population which are all dependent on petroleum, oil and related products either directly or indirectly could act as magnet for direct investors. This will serve double purpose as it will also reduce domestic prices of oil thereby also helping to control inflationary tendencies.

- Long term debt should be preferred over short term debt. Even within long term debt stress should be laid on multilateral and bilateral debt instead of external commercial borrowings.

- A separate department should be set up to strictly regulate External Commercial Borrowings.

- Special department in the ministry should be set up to identify sectors/industries giving rise to ECB/external debt.

- Efforts should be made on raising sovereign debt on concessional terms with longer maturities.