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NEW TRADE POLICY AND ITS IMPLICATIONS

30.1 INTRODUCTION

Trade policy of a country aims at regulating flow of imports and exports in accordance with the requirements of the economy. When an underdeveloped country launches programmes for its economic development, the volume as well as composition of its trade changes. The country starts importing large quantities of capital goods, raw materials and other essential goods required for development. Thus, its import bill keeps on mounting. On the other hand, its exports do not grow at the same pace. This is because many goods which it was exporting earlier, (such as raw materials, minerals etc.) it now uses in its own newly established industries. At the same time, the new products that it produces do not find market abroad because of their low quality and high production cost. The country has, therefore, to follow a trade policy which restricts non-essential imports and also helps in expanding exports so that development proceeds smoothly without creating balance of payments difficulties. The country may adopt a whole range of import control measures such as import licenses, import quotas, tariff (custom duties) structure and other types of import restrictions. It has also to be decided as to what goods should not be exported (to conserve them for domestic use) and how exports of other goods should be made to grow by such measures as concessions, incentives and encouragements to exporters. Trade policy covers all these instruments by which imports and exports are regulated to serve country's overall economic interests.

30.2 OBJECTIVES

After going through this lesson, you will be able to:

- explain the meaning of trade policy;
- explain why a country needs a trade policy;
- assess the working of Indian's trade policy;

- state why a new trade policy was needed;
- list the main features of the new trade policy;
- explain the implications of this new trade policy;
- explain the meaning of convertibility of the rupee;
- analyse how convertibility of rupee would help in expanding our exports.

30.3 THE PRE-REFORM TRADE POLICY

Ever since Independence, India's exports have continued to lag behind imports. The nagative balance of trade (excess of imports over exports) which was around Rs. 100 crores in 1970-71 widened to over Rs. 10,000 crores in 1990-91. While the country desperately needed to increase exports to finance the growing import requirements for our development programmes, our earnings from exports were far below the needed amounts. Consequently efforts were made through some systematic use of policy measures to control the volume of imports and encourage exports. Effective curb on imports and all out incentives for export promotion were thus the key elements in India's trade policy.

(a) Measures adopted to control imports

(i) Import licenses:

A complex system of licenses was introduced under which almost nothing could be imported without getting a license from government.

(ii) Import quota:

Under this, the maximum total quantity of goods that could be imported was prescribed. Permission was given to import the goods within this quantitative limit.

(iii) Tariffs (custom duties):

Under this, heavy import duties were imposed on imported goods so as to discourage imports as it makes them costlier and thus less attractive for domestic purchasers.

(iv) Import prohibitions:

Certain non-essential goods were not at all allowed to be imported.

(b) Objectives of import restrictions

These, and many other types of import restrictions were repeatedly justified on the grounds that:

(i) Heavy deficit in balance of payments:

There continued to be a heavy deficit in India's balance of payments. To minimise this deficit, imports must be reduced by some such tight control.

(ii) Reduce import of non-essential goods:

Imports of non-essential goods had to be minimised so that foreign exchange earned through exports could be made available for financing imports of essential goods like machinery, raw materials etc.

(iii) Protection of domestic industries from competition:

There was need to limit imports to protect domestic industries. Since that newly developing domestic industries could not compete with high quality and low cost foreign goods, they could not survive if free imports were allowed. Hence, imports had to be severely restricted so that goods produced by domestic industries could sell in the home market. The foreign goods were thus not allowed to enter the country and pose any competition to domestic producers.

While virtually nothing could be imported without government's permission, exports were left absolutely free of such control except for curbs on exports of some items which were needed to be conserved for domestic use or where exports were not in the national interest. In fact, exports were sought to be promoted through a variety of measures like tax concessions, cash grants, export subsidies etc.

30.4 NEED FOR REFORMS

The policy of placing restrictions on imports, however, did not prove very useful for the country. With practically, no competition from imported goods, the Indian producer could sell whatever be produced and this had no incentive to improve quality or reduce cost of production. Consequently, our low quality high cost products, which were sold in the protected Indian market, did not find any buyers in the world market. Our exports, therefore, failed to grow much inspite of all incentives and concessions to exporters. The balance of payment position continued to show persistent deficit and the foreign exchange reserves position become precarious. The situation became very alarming as in 1991 our foreign exchange reserves dropped down to about $1 billion. These reserves were hardly enough to meet import requirements of about two weeks where normally a country should maintain reserves to finance imports for atleast three months. The country had no resources to meet debt service payments and there was a danger that the country may default on its foreign debt obligations. Such a situation would have eroded India's credit-worthiness in international financial markets thereby shrinking the flow of foreign funds required for our development programmes. This economic crisis led to reforms in industrial, trade and foreign investment policies in India, reforms in fiscal policy etc.

POINTS TO REMEMBER

- The key elements of the Pre-Reform Trade Policy of India were : (i) Curbs on imports and (ii) incentives for export promotion.
- Imports were controlled through import licenses, import quotas, custom duties and import prohibitions.
- These controls did not prove very useful. So there was a need for reform in the trade policy.

INTEXT QUESTIONS 30.1

State whether the following statements are true or false :

(i) A developing country needs to regulate its foreign trade.

(ii) For a long time after Independence, India followed a policy of absolutely imposing no restrictions on imports.

(iii) Effective control on imports has been practiced in India through import license and tariff structure.

(iv) Imports of non-essential goods were freely allowed while developmental imports were restricted in India.

(v) Excessive restrictions on imports gave undue protection to domestic producers in India.

30.5 THE NEW TRADE POLICY

The new trade policy seeks to bring about major reforms in the policies. Reforms in trade policy include (i) reduction in tariff rates and rationalisation of tariff structure, (ii) liberalisation of import licenses and abolition of licensing requirements for many items of imports, and (iii) exchange rate reforms and move towards convertibility of the rupee. Let us study these reforms in detail:

1. Reforms in Tariff Structure

In India, rates of custom duties on imported goods had been continuously increased year after year for the purpose of giving additional revenues to the government. As a result, India became a country having highest tariff rates in the world. For example, in 1991 the highest rate of custom duty on any individual commodity was 355 per cent. The average tariff rate was also very high. It was about 87%.

Under the new trade policy, the tariff rates have been progressively reduced. Thus, in 1997, the peak tariff rate was brought down to half and the average tariff rate was reduced one-fourth. But even at this low level, India's tariff rates are much higher than the prevailing rates in some other developing countries. For example, the average tariff rates are around 12 per cent in Thailand, Indonesia and other developing countries of the East Asia. Average tariff rates are still lower at around 7 per cent in most of the developed countries. India, thus, needs to make still greater reduction in tariff rates.

2. Reforms in Import Licensing System

Until 1991 import license was required for import of almost all the goods. Thus every importer had to get a license from the government for the goods he wanted to import. The license document also specified the quantity of goods that could be imported. License was not granted for goods whose imports were prohibited. Nor an importer could bring in goods in quantity larger than the one that has been mentioned in the license. The licensing system thus imposed what is known as **'quantitative restriction'** on imports. Apart from these quantitative restrictions, the whole system of licensing was complex and inefficient. It resulted in long delays in grant of licenses. This led to corruption and unduly limited the volume of trade.

Under the trade policy reforms initiated in 1991, most of the licensing regulations earlier imposed on foreign trade have been abolished. Most imports have been taken out of the licensing system and made free. However a negative list of imports, which contains a small number of items, has been prepared. The items on the negative list still require license for the import. All other items which are not on the negative list can be imported without license. This negative list of imports (i.e. items for whose import license required) consists of all consumer goods, drugs and pharmaceuticals, chemicals and allied goods and items relating to small scale sector.

Controls on exports have also been liberalized. Now all goods can be exported without any restrictions. However, here in the sphere of exports, a negative list has also been made. Exports of items on the negative list are subject to regulation by the government. This negative list of exports contains such items whose export needs to be regulated due to strategic or environmental considerations. Goods that are essential for domestic use are also on the negative list. All items of cultural heritage are also placed on this list. India also does not permit export of birds, and wild animals in an unregulated manner.

Thus, while before 1991, foreign trade was regulated through import and export licenses etc. Under the new trade policy most of these licenses and controls have been abolished. Imports and exports are now largely free or unregulated. However, a small number of items, both on the negative list of imports and exports, still remain subject to license and other controls.

3. Reduced Role of Public Sector Trading Agencies

Another step towards deregulation of trade taken under the trade policy of 1991 relates to the sharp reduction in the number of items traded through the public sector trading organisations. Earlier these public sector organisations like the State Trading Corporation (STC), Minerals and Metals Trading Corporation (MMTC) etc. had a virtual monopoly of trading in some specific items. The idea behind giving such monopoly of trading to these organisations was that being large sized state enterprises, they could negotiate some price concessions or some other favourable terms for the goods imported through them. But their monopoly powers resulted in losses. Thus to ensure competitions and fair play in imports and exports, the new trade policy seeks to progressively reduce the number of items traded through these public sector organisations only.

4. Reforms in Exchange Rate Management

In an earlier lesson No.27B, you have studied about the process of exchange rate determination. In the open market, the exchange rate is determined by the forces of demand for and supply of foreign currency. Such a rate is called **'market determined exchange rate'**. If the exchange rate is fixed by the monetary authority (i.e. RBI in India), it is termed as **'official exchange rate'**. The two rates are generally different. If the official rate is higher than the market determined rate, the home currency is said to be undervalued. If it is lower, the home currency is said to be overvalued.

In India, the official exchange rate has always been lower than market determined rate. As such the Indian rupee remained overvalued. This caused our exports to grow slow while imports continued to increase even after import control and export promotion measures were implemented. The first move to reform this exchange rate was made in 1991. Rupee was devalued by about 20 per cent in two quick installments on July 1 and July 3 of that year. This exchange rate was expected to improve prospects for export of Indian goods and bring in increased foreign exchange earnings.

Subsequently, in March 1992, a Liberalised Exchange Rate Management System (LERMS) was introduced. Prior to this system, exporters had to surrender all their foreign exchange earnings to the Reserve Bank of India (RBI) at the official exchange rage. Under the new system introduced through LEARMS exporters were required to surrender only 40 per cent of their foreign exchange received from exports to the RBI at the official rate. The remaining 60 percent they were permitted to sell in the open markets. Since in the market, they could get more rupees for every unit of foreign currency than what they got under the official exchange rate, this provided an added incentive to the exporters to increase their exports. Thus, under the liberalised exchange rate management system two foreign exchange rates prevailed in the market viz. (i) the official exchange rate and (ii) the market determined exchange rate. This dual exchange rate system was designed to liberalise trade and initiate more towards the convertibility of the rupee.

In March, 1993, this dual exchange rate system was also abolished. It was replaced by a single exchange rate which was determined by the market forces of demand and supply. Now the rupee was made convertible on trade account. This meant that all the foreign exchange earned from the export of goods (merchandise) could now be sold in the market and thus converted into rupees at the market determined rate of exchange. Thus, the exporters were allowed to freely sell their export earnings (from export of goods alone) in the market. The importers were required to buy their foreign currency requirements from the market.

In March, 1994, there was further liberalisation in the trade as the rupee was made convertible on current account. This implies that all foreign currency earned by the exporters from both export of goods as well as export of services and that acquired foreign remittances could be sold in the market and thus converted into rupees at the market determined exchange rate.

However, rupee has not yet been made fully convertible. Full convertibility means making the rupee convertible both on current account as well as on capital account. Convertibility on capital account means freedom to convert foreign currency received from abroad on account of capital account transaction such as loans from banks outside India into foreign currencies (i.e. buying foreign currency in the market) at the market exchange rate for buying capital assets or for financial transactions abroad. So far, there is freedom to perform the first part, i.e., to freely sell in the market currency acquired through capital transactions. But the second part, i.e., conversion of rupees into foreign currency for doing financial transactions abroad is not permitted. Thus, capital account convertibility is still only partial. Efforts are continuing in this direction.

POINTS TO REMEMBER

- The new trade policy aimed at reforms in (i) tariff structure, (ii) import licensing system, (iii) role of public sector trading agencies, and (iv) exchange management.
- Import tariffs were reduced drastically.
- Most imports taken out of licensing system and made free.
- The role of public sector organisations progressively reduced.
- Rupee made convertible on current account.

INTEXT QUESTION 30.2

State whether the following statements are true or false :

(i) The new trade policy announced in 1991 seeks to liberalise foreign trade.

(ii) Under the new trade policy tariff rates have been raised on all items of imports.

(iii) Licensing regulations for a wide range of imports has now been abolished.

(iv) A negative list of imports contain those items for whose import license are still required.

(v) Rupee has been made fully convertible, both on current as well as capital account.

30.6 IMPACT OF REFORMS IN TRADE POLICY

Reforms in trade policy have yielded encouraging results. Liberalisation of foreign trade, abolition of import licenses over a very wide range of items, convertibility of rupee on the current account, have all contributed to infuse a new confidence among traders and thus contributed to the growth of our foreign trade.

(i) Impact on exports and imports of goods:

Exports have shown substantial improvement. Growth rate of exports which was negative (-ve) 1.5 per cent in 1991-92, marginally improved to 3.8 per cent in 1992-93, but thereafter jumped to 20 per cent in 1993-94, 18.4 per cent in 1994-95 and 24.2 per cent in the first half of the year 1995-96.

Imports which grew only by 12.7 per cent in 1991-92 and 6.5 per cent in 1992-93 due to recession in industrial activity, picked up and grew by 22.9 per cent in 1994-95 and 29.3 per cent in first half of 1995-96. The increase in growth rate of imports was the direct result of recovery of industry and the consequential growth of industrial output which used larger quantities of imported inputs and equipment.

(ii) Impact on invisibles

There was also a significant growth in invisible receipts, more particularly in foreign remittances to India in response to the incentives of a market determined exchange rate. Private transfer receipts which include such foreign remittances increased from $ 207 crores in 1990-91 to $ 620 crores in 1994-95.

(iii) Impact on current account balance

With the tremendous increase inflow of receipts on account of exports of goods and services, there was a significant improvement in the current account of balance of payments. The deficit on the current account narrowed down from $ 968 crores in 1990-91 to around $ 232 crores in 1994-95.

(iv) Impact on capital account

In the capital account of balance of payments, there was substantial improvement in the flow of foreign direct investment (FDI). The inflow of FDI increased from around $ 16 crores in 1991-92 to $ 480 crores in 1994-95.

(v) Impact on foreign exchange reserves

These improvements in current and capital accounts of the balance of payments resulted in building up of foreign exchange reserves. India's total reserves of foreign exchange which had depleted to an alarmingly low level of $ 100 crores in July, 1991 showed a continuous rise to reach $ 2900 crores in June, 1997.

Judged in the light of the above mentioned achievements, India's trade reforms can be said to be commendable. But there still remains a lot to be done. Tariff structure needs further reforms.

Task ahead

Although the peak tariff rates have been reduced, the average tariff rates still remains much higher than those of the other developing countries such as Thailand, Indonesia, Malaysia etc. The negative list of imports (list of items for the import of which licenses are still required) still covers an enormous range of goods and, therefore, needs to be pruned.

However, in our enthusiasm to push the reforms further, we must learn some lesson from the growth records of Asia's fast growing countries, popularly called the Asian Tigers. These countries include South Korea, Thailand, Philippines, Taiwan, Indonesia and Malaysia. Some of these tiger economies, which recorded rapid growth rate through export oriented growth strategies are now facing slow down and a currency crisis. Trade experience of these countries shows that indiscriminate liberalisation does not guarantee, for all time, generation of foreign exchange inflows that are sufficient to meet external obligation.

The experience of these countries also shows that India should not take hasty steps towards capital account convertibility as it would facilitate currency outflows and adversely affect foreign exchange reserves.

POINTS TO REMEMBER

- Reforms in trade policy have yielded encouraging results.
- Exports have shown substantial improvements.
- Significant growth of invisible receipts.
- Significant improvement in current account balance.
- Substantial improvement in the flow of direct investment.
- Rise in foreign exchange reserves.

INTEXT QUESTIONS 30.3

State whether the following statements are true or false:

(i) For some time, two exchange rate prevailed in India, of which one was official and the other was market determined.

(ii) Trade policy reforms are aimed at improving India's export competitiveness.

(iii) Convertibility of the rupee on current account has provided incentive to the exporters.

(iv) The new trade policy has improved balance of payments position and increase foreign exchange reserve.

WHAT YOU HAVE LEARNT

Trade policy aims at regulating the flow of international trade in accordance with nation's economic requirements. Since Independence, India has been following a policy of placing restrictions on imports to save foreign exchange for import of goods required for development. Variety of instruments such as licenses, permits, quotas, tariffs etc. were used to effectively keep a check on imports. Export promotion measures such as tax concession, subsidies etc. were also adopted.

However, the policy of severe import restrictions created a protected market for the domestic industry. This resulted in production of low quality high cost goods which could not compete in the world market. Thus our exports failed to grow significantly inspite of all incentives to exports, causing strain on the balance of payments. Situation becomes worse in 1991 when our foreign exchange reserves depleted to an all time low level of $ 100 crores. Consequently, reforms were made in trade policy and the new policy was announced in 1991. Under this policy, tariff structure was rationalised and reduction in duties were made on most of the items of imports, licensing regulation were withdrawn on all imports except those contained in the negative list of imports, reforms were made in the exchange rate system, and the rupee was made convertible on current account.

The impact of these measures to deregulate and liberalise trade has been encouraging.

Export growth rates have increased and current account deficit narrowed down. Inflow of foreign capital improved and foreign exchange reserves reached new high of $ 2900 crores in 1997. However, reforms are still needed to be pushed further. But in doing so, experience of some other countries of East Asia must be carefully analysed so that country does not face the crisis being faced by those economies.

TERMINAL EXERCISE

1. Briefly describe the need for reforms in the trade policy followed in India since Independence till 1991.
2. Explain the main features of the new trade policy announced by the government in 1991.
3. 'Policy of liberalisation has helped India to expand its foreign trade with less strain on its balance of payments'. Discuss.
4. What is the impact of trade policy reforms on India's exports and balance of payments position?
5. Write a note on convertibility of the rupee.

ANSWERS

Intext Questions 30.1

(i) True (ii) False (iii) True (iv) False (v) True

Intext Questions 30.2

(i) True (ii) False (iii) True (iv) True (v) False

Intext Questions 30.3

(i) True (ii) True (iii) True (iv) True

Terminal Exercise

1. Read section 30.4
2. Read section 30.5
3. Read section 30.5
4. Read section 30.6
5. Read section 30.5(4)