

# **TROUBLE WITH IMPORT SUBSTITUTION AND PROTECTIONISM: A CASE OF INDIAN ECONOMY**

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## **Abstract**

Indian economic experience of last 50 years has been one of missed opportunities in early part, lessons learned in the middle and an incomplete implementation of correct economic policies at the latest period. The early years were marred by phony faith in protectionism and import substitution. This created a lot of economic inefficiencies. This paper reviews the theoretical arguments of free trade and applies them to experience of Indian economy. A comparative analysis of Chinese economic performance shows that even if India missed the opportunities early, there is a room for expecting bright future if right policies are implemented with vigor and with a sense of urgency.

# TROUBLE WITH IMPORT SUBSTITUTION AND PROTECTIONISM: A CASE OF INDIAN ECONOMY

## Introduction

Over the course of the past few years, the world has grown increasingly interconnected. In 1940 to 2002 period, the world trade volume has grown by 1800%, there are better transportation and communication techniques available, and awareness of each other's business environment is greatly improved. The invention and subsequent advent of progressively more advanced levels of communication and transportation technology has enabled the transfer of goods and information across distances to take place on a much more efficient basis. Add to this the natural instinct of many countries to attempt to minimize costs (*production, supply and otherwise*) while generating increased revenues (*expand markets/increase sales*), and it is easy to recognize how International Trade has come to represent such a large component of late 20<sup>th</sup> and ongoing 21<sup>st</sup> century business practice.

In light of the many potential benefits of International Trade such as increased sales/revenues, cost reductions, technology transfers, the search for higher quality products, industry development, general economic growth... etc., several countries have surprisingly either chosen to abstain altogether from the practice of trading goods and services (*imports, exports or both*) with other nations, or simply imposed economic and regulatory hurdles designed to drastically restrict the flow (*import/export*) of tradable goods and services across their borders. More specifically, countries such as China, Cuba, Iraq, India and even the United States, to a certain degree at some point in their history, subscribed to one form of protectionism (*trade control*) or another.

The aim of this paper is to identify and analyze the underpinning rationale which govern a country's decision to avoid International Trade, as well as identify some of the possible repercussions of this decision. In doing so, we will focus much of my attention on India. In this sense, we document not only India's historical perceptions of, and strategies pertaining to international trade (*protectionism and import substitution vs. free trade as a means of fostering individual industry as well as overall economic growth*), but also general economic theories (*David Ricardo's thoughts on Comparative Advantage and the Heckscher-Ohlin Theory*) as they relate to specific elements of the ongoing International Trade argument in India. In addition, we prove not only that the practice of International Trade benefits the overall welfare of the countries involved, but also that India's anti-trade policy of Import Substitution, in the mid to late 20<sup>th</sup> century, severely retarded the country's economic development.

However, there are a couple of definitions that need to be clarified. First, the World Trade Organization defines **International Trade** simply as the exchange of goods and services across international borders ([http://www.wto.org/english/thewto\\_e/glossary\\_e/glossary\\_e.htm](http://www.wto.org/english/thewto_e/glossary_e/glossary_e.htm)). This definition includes transactions which occur based on either a good for good/service for service basis swap, or a good/service for commodity (*money*) swap. Similarly, Paul Krugman and Maurice Obstfeld, define International Trade as pertaining to real transactions that involve the physical movement of goods or a tangible commitment of economic resources across national borders (Krugman et al. 2003).

Second, the idea of Import Substitution Industrialization, also known as ISI, refers to a trade and economic policy based on the premise that a developing country should attempt to substitute products which it imports (mostly finished goods) with locally produced substitutes. This often times involves government subsidies, high tariff barriers and/or artificially maintained domestic currencies to protect local industries ([http://encyclopedia.laborlawtalk.com/Import\\_substitution](http://encyclopedia.laborlawtalk.com/Import_substitution)). Import substitution can also be discussed as a policy strategy, e.g. as an attempt to utilize underused capacities, reduce regional unemployment or protect infant industries. This form of economic

protectionism has helped some countries industrialize in the past, (such as South Korea and Taiwan) but these steps can be fraught with economic risks, most notably potential economic inefficiencies, uneconomical use of available resources, and ultimately leading to higher prices (<http://faculty.washington.edu/krumme/gloss/i.html>).

## **Related Theory and Literature Survey**

It seems best to begin this analysis of the rationalization of International Trade by reviewing some of the earlier, more highly regarded economic theories which pertain to it. For instance, economic theorists such as David Ricardo, the Swedish duo, Professor and student team of Eli Heckscher and Bertil Ohlin have come to be very well respected within the international economic community for their early works pertaining to international trade, and more specifically the mutually beneficial nature derived from the *strategic* implementation of this trade. Added to this the neoclassical economists revolution of early 1900s offered substantial support to the argument that free trade benefits economies in many different ways.

Popular economic discussion relating to International Trade revolves around ideas supported by two main schools of thought. The first of which was espoused by David Ricardo. Ricardo supported the concept that strategically based trade between separate nations would result in both nations becoming better off (Ruffin 2002). Essentially, given a select set of environmental assumptions, trade would allow each nation to come away from the engagement with a higher level of satisfaction and a better mix of resources than was realizable before or without trade. The fundamental understanding in this argument was that in a model involving two nations, each producing two products while using one factor of production (*labor*), each nation would come into the engagement with a certain level of relative efficiencies of production. Ricardo maintained the idea that beneficial trade would then occur as each country comes to rely on individual comparative advantage, or when each nation produces the product that is relatively less expensive to produce (*from both an efficiencies of production as well as an opportunity cost stand point*), and trades what is left over after consumption for the

product which would have been relatively more expensive to produce domestically. The end result being that each nation comes away from trade able to realize a greater amount of product than would have been the case had she produced everything her-selves. Thus the main reason for Ricardian argument to prove the gains form international trade was the difference in technology of production across countries for the same good. In 1912 however, Heckscher-Ohlin proved that even if technology of production of same good across countries was exactly the same, a beneficial trade can still occur because countries possess different factor endowments. By extending further the argument of beneficial trade and by using the then sophisticated microeconomic tools such as community indifference curves and production possibilities curve, a bunch of neo-classical economists proved that the gains form free trade are undeniable. Nonetheless some countries especially India, did not pay attention to these theoretical developments.

### ***Implications for India***

Application of this Ricardian theory on a more country specific level can be accomplished by looking at India, in terms of her production capabilities as well as her trade relations. In this sense, the Ricardian model suggests that India should be able to take advantage of International Trade by specializing production on goods in which she holds comparative advantage (*e.g. Jute, Mangos, Technical Services, etc...*), and then exporting or trading these goods to other nations for goods in which India's opportunity cost of production is relatively higher (*Autos, Airplanes, etc...*). This relationship would result in India, as well as the other nation, being able to obtain certain products (*via trade*) which would otherwise be relatively more expensive or inefficient to produce domestically. Over time this type of trade would prove beneficial to India as a whole since resources of production which would have otherwise been tied up or spent on inefficient production would then be freed up to be redistributed toward other endeavors or invested elsewhere.

India, however, has taken a different approach towards spawning industry specific as well as economic-wide development. Upon realizing independence from British rule in 1947, Indian leaders aspired to develop and maintain a greater level of Indian self-sufficiency in

terms of production. At the same time, one of the new government's main objectives was to adjust in such a way as to make inroads towards alleviating much, if not all, of the poverty that was overwhelming the country. Gandhian followers were in much faith with "self reliance" (or Swadeshi) movement, thinking that India does not need to depend on rest of the world, she herself was seen to be such a big and self sufficient country. However, as history proved it quickly, there was an inherent illogic in this argument.

Ricardo would have seen this as the perfect opportunity to implement trade as a means of taking advantage of India's comparative advantages in the production of agricultural goods and swapping the excess for industrial goods and technology from other countries. This way India could access capital and technologically oriented goods, which in addition to helping satisfy domestic demand for these products could be used to help develop India's own fledgling industrial industries.

India, though, moved in the opposite direction, accepting a more centralized and restrictive government which utilized import substitution, import quotas and significant tariffs in taking a more methodical and isolationists approach to development (Frankena 1974). For example the Industrial Policy Resolution of 1948 gave the Indian government a monopoly in armaments, atomic energy, and railroads, and exclusive rights to develop minerals, the iron and steel industries, aircraft manufacturing, shipbuilding and telephone and telegraph equipment and infrastructure (<http://www.cia.gov/cia/publications/factbook/geos/in.html#Econ>). Additionally, controls over prices, production, and the use of foreign exchange, which were imposed by the British during World War II, were reinstated soon after independence. The Industries (Development and Regulation) Act of 1951 and the Essential Commodities Act of 1955 (including subsequent additions) provided the legal framework for the government to extend price controls that eventually included steel, cement, drugs, nonferrous metals, chemicals, fertilizer, coal, automobiles, tires and tubes, cotton textiles, food grains, bread, butter, vegetable oils, and other commodities (Narula 2002). By the late 1950s, controls were pervasive, regulating investment in industry, prices of many commodities, imports and exports, and the flow of foreign exchange.

As this policy evolved and matured, and the Indian government took an increasingly hard-line approach towards allowing specific amounts of imports, of only certain goods, to enter the country, it became all the more clear that the planned degrees of economic growth India had been counting on were not going to develop. Furthermore, India's policy of import substitution was depriving many industries of the required inflow of increasing levels of technology with which to build upon. In fact the lack of competition and mass government subsidies allowed many business and economic inefficiencies to go unchallenged and undisciplined within the economy. This created an environment where in addition to resources not being allocated efficiently, industries were not motivated to continue product development and evolution, and products quickly became vastly outdated. By attempting to satisfy all elements of production within her economy rather than taking advantage of her relative strengths (*specialize in producing products in which India had a comparative advantage and trading the excess for other goods*), India's economy was in a state of stagnation, and in certain instances even moving backwards.

### ***Heckscher-Ohlin***

Similar to Ricardo's theory on Comparative Advantage, the Heckscher-Ohlin model (H-O model), originally developed by Swedish economists Eli Heckscher and Bertil Ohlin during the 1910s, also deals with the inherent benefits of international trade as it relates to the welfare of participating nations (assuming many of the same environmental constraints). The H-O model, (*aka. The Factor Proportions Model*), incorporates a second factor of production (Capital) into the production and trade equation. The model first points out that individual nations are stronger (*relative to other nations*) in terms of their endowment of, or access to, either labor or capital (*labor/capital abundant*). Secondly the model points out that individual goods also differ in terms of how reliant they are on either labor or capital resources during the production process (*labor/capital intensiveness*). Therefore, the H-O Model ultimately portends that it is best for nations, after identifying whether they are labor or capital abundant, to specialize in producing products which are more intensive in the same respect as their abundance (Krugman et al. 2003). In essence, the H-O theorem says that a capital-abundant country will export the

capital-intensive good while the labor-abundant country will export the labor-intensive good. The theorem then follows, that mutually beneficial trade can occur between two nations, which specialize in different goods, as each trades its excess domestic production for the others. This way each nation is able to acquire both products at a lower overall cost of production than otherwise would have been possible on their own (*without trade*).

### ***Factor Price Equalization Theorem***

The H-O Theorem was also expounded upon by an American Nobel Prize winning economist, Paul Samuelson, in the 1930s to include specific insight on the effect trade has on income distribution and employment rates within participating nations. More specifically, Samuelson theorized that as two nations engage in trade, market forces will dictate a redistribution of production resources within the nations as prices adjust to meet changing demand (Krugman et al. 2003). Similarly, the corresponding prices of the specific factors of production within the two nations will also move towards equilibrium (*wages of the workers and rents earned by owners of capital*), assuming full employment of the workforce exists before trade. In essence, in a labor abundant nation, as that nation specializes in and begins to export labor intensive goods, relative demand for labor will increase as will the relative wages (or employment rate) of the workers. This occurs until equilibrium is reached between the wage rental ratios of the two trading nations. In this way free trade provides incentives for nations to take advantage of their relative strengths and factor endowments by specializing and exporting excess domestic production abroad. This is also known as the Factor Price Equalization Theorem.

### ***Implications for India***

Again we can see the potential implications for India to reverse some of the poor economic fortunes and vast income disparities that exist within the nation. And once again the remedy appears to be free trade, or at the very least a move in that direction. In this regard, it should be recognized that India is a labor abundant nation (1.1 billion people) relative to just about any other industrialized nation on earth. It should also follow then, that India would have been better served to, first have embraced a greater semblance of free trade, after gaining independence, by creating an environment where

goods were allowed to travel unimpeded across national borders, and second specialized in allocating resources to and producing labor intensive goods such as agriculture and textile goods (i.e. clothing, linens, shoes, mining, etc...) which could then be traded to other, more capital abundant, nations for capital intensive, higher technology goods. This way India would have been able to not only acquire a better mix of goods less expensively, but also obtain relevant technologies necessary for their own industrial evolution, effectively lower the nation's overwhelming rate of unemployment and quite possibly increase the wage rates, and living standards, of the nation's agriculture and textiles workers (wealth redistribution).

As history points out though, India, in its implementation of Import Substitution from 1947 through 1985, turned away from the policy of free trade, choosing instead to manipulate the distribution of national resources. India decided that this tactic would allow the nation to produce a wider range of total products (*regardless of comparative advantage*) rather than specializing only on those industries in which the intensive factor present in production matched India's strength or abundance as a nation. In hindsight, this strategy failed in almost every respect. It did allow India to manufacture a fairly wide array of products, but as it turned out the quality of those products was very poor and the lack of direct competition created an environment where product improvement and evolution was painfully slow, if present at all. Furthermore, overall wealth was eroded in the sense that stiff government regulations and generally inhospitable conditions dictated that Foreign Investment coming into India was almost non-existent.

Of course this was not the intended function of Import Substitution. Rather, a government dedicated to Import Substitution believes that an effective, if not efficient, mix of products can be produced via Import Substitution as long as the government is committed to setting prices and maintaining production budgets rather than allowing the market to dictate them (Frankena 1974). In fact some governments, engaged in protectionist policies such as Import Substitution, actually believe that free trade destroys competition and manipulates prices by promoting collusion and monopolistic

environments, quite the opposite of what economists like Ricardo, Heckscher and Ohlin contend.

Over time, India's government has gradually amended its policy on Import Substitution, recognizing that certain levels of outside trade, and the competition that it invites, are necessary to promote large scale economic growth. The problem now seems to be that the recent economic and political system in India has bred a sense of complacency, or better yet fear of the idea of losing one's safety net and becoming worse off than they already are. Many point to the elaborate system of government subsidies in India, aimed at supporting domestic (*government owned*) business regardless of that business' ability or track record, as the cause of this lack of motivation. This seems to be yet another by product of import substitution. That is, the fact that government tends to breed market inefficiencies by handing out subsidies and keeping poorly run and vastly inefficient business afloat even if the invisible hand of the market pleads otherwise. In India this scenario can be witnessed throughout the economy from factories which turn out outdated electric fans to agricultural technology still in indigenous states of development to manufacturing companies producing scooters which are obsolete as soon as they come off the line (Frankena, 1974). In fact, it can be said that an "effective" Import Substitution policy can cripple a business' long term ability to remain competitive as ingenuity and creativity, which are normally bred and spurred along by direct and indirect competition, are crushed and replaced by complacency and inefficiency.

### **Empirical Analysis**

The objective of this next section is to better illustrate, via empirical data, the effect India's decision to implement Import Substitution has had on industrial development and overall economic health within India. In doing so, we will analyze data pertaining to Indian economic health in and around the period of Indian Import Substitution (post 1947 to pre 1991); relative to other less developed countries (*LDCs*). The next step will be to analyze similar economic statistics from 1991 on (*this is the year India began to relax import regulations and started to move towards more liberalized trade*), once again relative to other LDCs. This will allow us to infer not only the effects India's decision to

implement Import Substitution has had on the nation's growth patterns, but also India's prospects for future growth.

### ***Economic health during Import Substitution***

We begin by taking a look at a series of statistics which will give us a better idea of the general health of the Indian economy during the 40 or so odd years during which the government was engaged in protectionist trade policies. More specifically though, we observe per capita Gross Domestic Product (GDP), GDP growth, Foreign Direct Investment (FDI), tariff levels, trade deficit/surplus, external debt levels, inflation rates and poverty characteristics. This is certainly not an exhaustive list of economic indicators, but it should be adequate to ascertain India's general economic health over a period of time. In doing this analysis we also compare the Indian economic growth performance with another large Asian economy, China.

In case of China, although some data were difficult to come by due to not only the restrictive nature of the Chinese government's data disseminating sources, but also due to limited data-sets made available by the World Trade Organization. Nonetheless we have gathered statistics from a relatively wide range of dates. In testing the hypothesis that protectionist trade policies, such as the policy of Import Substitution imposed by the Indian government in 1947, severely restrict economic growth in the country which imposes them, we begin by analyzing the general status of the Indian economy in 1970. In addition to offering a more comprehensive data-set, this time period presents a clearer image of some of the developing effects of India's protectionist trade policies. More specifically, data-sets compiled from years closer to India's implementation of protectionist trade policies make it more difficult to recognize specific trends and effects.

### ***Gross Domestic Product***

One of the more popular statistics used to gauge a country's economic health is the level of GDP within that country. GDP is considered a prime component, of an accurate

representation of a country's general level of economic health, as it measures the level of value adding productivity that is taking place within that country. As can be witnessed in **(Exhibit 2)**, India (1970) had a GDP level of roughly \$141 billion (measured in current U.S. \$). For a normal sized country this might have been halfway respectable, but when the number is further broken down, in terms of the GDP per Capita (relative share of GDP per person)**(Exhibit 3)**, the number equates to only \$18, lower than practically two thirds of the world's Less Developed Countries (LDCs). During this same time China, registered GDP of roughly \$205 Billion with a GDP per capita of \$24.

### ***Foreign Direct Investment***

FDI, which in this usage concerns the flow of investment money or other forms of capital from a foreign country or investor into India, also plays a large role in dictating economic growth. In fact, many countries depend vitally on a relatively large annual allotment of FDI, in the form of not only foreign currency, but also technology, distribution centers and even complete manufacturing facilities (*among other forms*). This FDI allows the host country access to resources which would otherwise be unavailable to it, and enables the host country to benefit from the increased levels of technology which often accompany FDI. In this sense FDI is often times an active component in the development of individual industries within a developing country. In fact, many developing countries see FDI as an opportunity to capitalize on their comparative advantage and therefore they announce rewards and subsidies to attract the foreign direct investment (*tax breaks, reduced environmental and legal regulations, etc...*) to accommodate potential foreign suitors. However, the environment in India following the 1947 imposition of Import Substitution policies by the Indian government was not viewed by many to be friendly or fruitful to foreign investors. In fact, the active trade barriers combined with a general disregard for private property rights by the Indian government was the main impetus in foreign company's wholesale avoidance of India for the last half century. This can be seen in **(Exhibit 5)** which shows the effects of 40 years of trade protectionism, in that India(1991) was only able to attract \$100 million (*measured in current U.S. \$*) in FDI versus over \$11 billion for China.

### ***Tariff Rates***

The next significant statistic we will be using to help explain the general economic health of India is her average tariff rates. This can be more clearly seen by referencing (**Exhibit 8**). In fact India supported average tariff rates of between 150-300% throughout much of the 1950s-90s, while at the same time other LDCs in South Asia, like China were supporting average tariff rates of roughly 45%, Nepal (18%) or Bangladesh (22%). This is, without a doubt, the most important statistic when it comes to explaining India's economic misfortunes, as it acted as the linchpin of the country's trade policy from 1947 thru 1991, and drives many of the other important economic indicators. In other words, India's plan of dissuading foreign imports by raising tariffs to outrageous levels couldn't have worked more effectively in the sense that it essentially erected a border around the country which was nearly impenetrable to foreign goods. In fact, the plan worked so well that for over 40 years Indian products were produced in an environment almost completely void of any competitive or efficiency minded forces.

This is where the true philosophical differences between protectionist and free trade oriented policy abound. Pro-Trade policy is supported by the belief that trade invites competition which in turn breeds efficiency and high quality. Protectionists, by comparison, believe that free trade too often breeds collusion and inefficiency in the sense that it can create monopolistic environments. In this way, by removing unnecessary outside competition, protectionist policies, such as Import Substitution, ultimately spur on individual industry growth by creating a fairer playing field and more even handed support (*government subsidies*) (Goldar 1986). Unfortunately India was not able to reap the rewards of her protectionist policies, as the lack of true competition created an environment where ingenuity, creativity and efficiency went largely unrewarded, and government subsidies allowed even the most ineffective companies to remain in business.

### ***Trade Balance and External Debt***

The next two economic indicators can be examined in tandem as they relate directly to each other. That is, statistics regarding India's trade balance and her levels of external debt. As can be seen on (**Exhibit 7**), India's balance of trade was relatively small, although negative nonetheless, throughout much of the time between implementation of Import Substitution in 1947 and liberalization of that policy in 1991. Initially this seems like it would be a positive statistic as export levels come fairly close to covering the levels of imports (*cash in covers cash out*). When considering the government's policy of mass subsidies (*cash out*), along with the general levels of poverty within the country as explained later in this paper (*no tax income*) though, it becomes more apparent that India had become very reliant upon external sources of financing (*loans and other debt structures*) to support her growing balance of payments deficit. The problem came to a dramatic head in August 1990 when Iraq invaded Kuwait, and the price of oil soon doubled. Additionally, many Indian workers who had resided in Persian Gulf states either lost their jobs or returned home out of fear for their safety, thus reducing the flow of remittances.

The direct economic impact of the Persian Gulf conflict on India's balance of payments, and overall debt condition was exacerbated by domestic social and political developments as well (*i.e. government ceding public sector jobs only to Scheduled Castes and the Hindu-Muslim conflict in Ayodhya*) (Narula 2002). The central government then fell in November 1990 and was succeeded by a minority government. The cumulative impact of these events shook international confidence in India's economic viability (*once again negatively affecting FDI*), and the country found it increasingly difficult to borrow internationally. As a result, India was forced to enter into various agreements with the International Monetary Fund and other organizations that included commitments to speed up trade liberalization, thus putting an end to Import Substitution policies ([http://lcweb2.loc.gov/cgi-bin/query/r?frd/cstdy:@field\(DOCID+in0098\)](http://lcweb2.loc.gov/cgi-bin/query/r?frd/cstdy:@field(DOCID+in0098))).

**Exhibit 9** illustrates the sudden growth of India's debt stock relative to other LDC countries (*China and Mexico*). It can be seen that dramatic events of the early 1990s when combined with accumulating effects of Import Substitution resulted in a 300%

increase in India's level of debt stock between 1980 and 1990. This obviously has long reaching affects on India's financial health as the subsequent debt service payments take up a significant chunk of the country's yearly capital flows, which means a smaller piece of the pie is left for dearly needed social and infrastructural initiatives.

### ***Inflation and Quality of Life Indicators***

In this sense, in attempting to judge a country's overall economic health it can also be quite telling to look at specific social indicators such as poverty levels, literacy rates, consumption levels and life expectancy as well as examining the degree to which the government has addressed infrastructural issues such as communication, sanitation and transportation systems within the country. Thus, in addition to noting India's problems with maintaining price levels and inflation, in this section we also attempt to describe the general quality of life produced by India's Protectionist policies.

Consider consumer price levels, which are important indicators as to the general purchasing power of a country's population. **Exhibit 6** indicates that, generally speaking, India has avoided some of the hyper inflationary problems evident in some other LDCs (*i.e. Brazil, Argentina, Indonesia and Mexico*), and due to relatively sound monetary policies has been able to keep inflation relatively stable. In fact this has been one of the main priorities of the Indian government thru the years. So even though the majority of India's population does not have much money to spend, they can feel relatively assured that the prices of the goods that they can purchase will remain fairly stable.

What's more concerning though is the general level of poverty that exists throughout India. Statistics show that roughly 400-450 million people in India live below the world's poverty level, (*that's approaching half of India's total population*). In fact, food availability for the average Indian increased only 29% over 41 years (*from 395 grams per day in 1950 to 510 grams per day in 1991*). Furthermore, after 41 years of Import Substitution, and all the economic and industrial growth which was predicted to stem from it, life expectancy in 1990 was about 60 years, a quarter of Indian people did not have any access to safe water, as much as 87 per cent did not have any sanitation facility and roughly 48% of the Indian population was considered illiterate. Furthermore, during

the second half of the 'eighties, for every 2,520 Indians, there was only one doctor available, while only one nurse was available to 1,700 Indians (Y.V. Reddy).

Many of the aforementioned growth indicators show that the performance of the Indian economy during the post-Independence period up to 1990 was at its best during the 1980s, but there were deep structural imbalances. These problems arose in the form of structural rigidities, lack of competition both at home and abroad, poor performance of public sector industries, lack of fiscal prudence (*tax and spend policies*) and an incentive framework which was inconsistent with productivity gains. It seems clear, much of this can be attributed to India's implementation of protectionist policies from 1947-1991. More specifically, the general lack of financial resources, due to nearly non-existent FDI levels, resulted in diminished levels of direct financial support from the Indian government towards the Indian population (*little is left after large sums are spent on subsidies to support inefficient industries*). In other words, while other LDCs, (*i.e. China and Chili*), were devoting substantial energies and funding towards developing educational and infrastructural (*roads, communication, power and water/septic*) systems, which allowed these countries a better platform from which to build long term growth, India ignored these issues in lieu of the idea that they would be able to just financially muscle inefficient industries towards growth themselves. In the short, as well as long run, this proved to be futile, and it turned out to be the Indian people who paid the price.

### ***Trade Liberalization***

As alluded to earlier in this paper, India's decision to move away from its Protectionist policy of Import Substitution, instead adopting a more trade friendly position was in large part dictated by the country's balance of payments crisis in 1990 (*considering that IMF loans were tied to the adoption of more liberalized IMF trade policies*). With that said though, it can not be overlooked that India, in part, made the switch over to "free trade" oriented policies due to the fact that forecasted benefits from Import Substitution, such as increased economic growth along with individual industry growth and improvement in the overall welfare of the population, had fallen far short of expectations.

Truth be told, conditions associated with the IMF's nearly \$10 billion dollar bailout loan to India (*2 separate loans of nearly \$5 billion each in 1991*) proved to be the deciding impetus involved in the move towards more liberalized trade policies (<http://www.peoplesmarch.com/publications/globalisation/chapter1.htm>). In fact, the IMF ties a number of conditions to the approval of any of their loans. Most are designed not just to resolve the immediate balance of payments problem, but more importantly, to lay the foundation for sustainability and economic growth over the longer term by achieving broader economic stability as was the case with India. In this sense, the following steps of action represent specific conditions offered up by the World Bank to the government of India under which loans would be offered (<http://www.iew.org/world-c10-p1.html>):

- Devaluation of rupee by 23%.
- New Industrial Policy allowing more foreign investments.
- Opening up more areas for private domestic and foreign investment.
- Part disinvestment of government equity in profitable public sector enterprises.
- Sick public sector units to be closed down.
- Reforms of the financial sector by allowing in private banks.
- Liberal import and export policy.
- Cuts in social sector spending to reduce fiscal deficit.
- Amendments to the existing laws and regulations to support reforms.
- Market-friendly approach and less government intervention.
- Liberalization of the banking system.
- Tax reforms leading to greater share of indirect taxes.

This list was by no means meant to be a fail safe plan of attack, which after implementation would guarantee economic growth and long term success in India, but it was viewed by the World Bank as a step in the right direction.

In fact, after re-visiting several of the statistics analyzed previously in this paper it can be seen that India's economic health has begun to improve. For example, GDP (FY2003)

has increased by nearly 350% over FY1990 levels (**Exhibit 2**). Accordingly, GDP per Capita in India realized an increase of \$431 over the same time span (**Exhibit 3**). Tariff levels, though not at ideal levels yet, have dropped dramatically over the course of the last 15 years (**Exhibit 8**), averaging roughly 20% across the board, with further reductions planned for the future. As a result, trade (export) levels have picked up dramatically, increasing nearly 750% or \$54 billion dollars (valued in current U.S. \$) since 1990, while imports have increased seven fold to over \$76 billion annually (**Exhibit 10**). Consumer price levels have also seen an increase in stability as inflation has gradually decreased to between 3-5% annually (**Exhibit 6**).

With that said though, there are also certain indices which will require more time to show significant signs of improvement. FDI levels in India continue to lag behind corresponding levels in other LDCs. In fact China has witnessed considerable growth in their levels of FDI (**Exhibit 5**) over the past decade due to increasing investor confidence in not only China's stability and security but also the country's level of potential profitability. Another reason for this difference in foreign investment is the relatively advanced stage of infrastructural development witnessed in China relative to India. Investors are able to operate more efficiently in China due to more established transportation and communication systems as compared to India.

### ***Prospects for Future Growth***

The bad news right now, is that India has current debt levels as high as, or higher than two thirds of the World's LDCs. This is significant in the sense that servicing this debt will require large sums of cash flow be re-directed away from fueling industrial and infrastructural growth. The good news is that through prudent IMF sponsored policy reforms, increasing levels of FDI and gradually improving trade competitiveness India is at least pointed in the right direction and may eventually be primed to finally take advantage of her country's labor abundance and seemingly limitless potential.

Progress will be slow, and eventual competitiveness throughout India's network of infant industries will almost certainly be delayed as many of these industries have yet to outgrow the constraints of India's previous protectionist policies. In fact, it can be said that India's trade policies of recent past have effectually crippled India's industrial sectors by, among other things, creating an environment where bureaucratic logjams clog the path to efficient business practices; breeding attitudes of indifference by subsidizing inefficient and poorly run businesses; and in general, ill-preparing them for the rigorous competition inherent in free trade.

Although conditions are better, relative to pre-liberalization times, the road to prosperity (or *with an eye more towards the immediate future, the road out of destitution*) will not be short or easy. India must first make up for lost time and start prioritizing social and infrastructural development before any real economic progress can be attained. Funding of the country's educational and healthcare systems must improve drastically as the future of India's industries will depend largely upon the quality of her population. The effect of this type of decision can be seen in the increased development of India's northern neighbor (China). In this sense, due to China's relatively early prioritization of education and social spending (with dollars earned from increased levels of FDI) the country has become more attractive to and welcomed foreign investors by developing a reservoir of highly desirable human resources.

Additionally, in order to achieve growth India must address its infrastructural ineptitudes. Not only does the country lack a competent network of highways, which effects the transportation of goods and people, it also needs to develop a better capacity for supplying resources such as sanitation/water and energy. Here inlies the crux of India's problems though, the question of where to get the money to accomplish these objectives. The solution is increased FDI. India needs to stabilize the political structure and become more transparent in a way that allows foreign investors a better idea of exactly what to expect when entering India. Progress on this front has certainly been made, as recent history has witnessed not only a stabilizing party in government, but also changes within the Foreign Investment Promotion Board (FIPB) which are geared at speeding up and

standardizing the investment clearances process. Once foreign investors feel sufficiently safe, FDI levels should increase, which in turn will allow infrastructural project spending to increase within India, all happening in a cyclical type manner.

According to Dr. Y.V. Reddy, “Both the medium term challenge, relating to institutions and infrastructure as well as the longer term one relating to social development, demand a more focused government and a government that efficiently delivers the essential services that it is supposed to deliver, as an overarching priority. What India needs is not necessarily less government, and not even more market, but better government and genuine market” (Y.V. Reddy). Development can take place in India if the “powers that be” decide to work together on a plan that prioritizes the overall welfare of those involved via cooperation and mutually beneficial engagements.

In terms of industrial sector development within India, while it has been said that India might be best served to rest its hat on the glut of engineering, software and IT jobs which have been outsourced to the country as of late (statistics show that by 2020 these service jobs are expected to generate 24 million jobs), the fact that some 200 million young people will be waiting to enter the job market by 2020 dictates that the Indian industrial sector must continue to diversify and grow to accommodate India’s ever surging labor supply (Kripalani, 2003). As can be seen by viewing India’s distribution of exports in 1999 (**Exhibit 13**), manufactures represent over 77% of the value of India’s total exports. This displays India’s relative strength in manufactures (even considering its inefficient history), and hints that the country has a relatively wide array of industries with which to build on. The main struggle for India now is to replace the overarching mentality propagated by the Import Substitution policies of the last half century with a new fervor towards efficiency and competition. Companies need to develop and refine their sense of ingenuity and creativity which was suppressed by the previous policies of subsidies and quotas.

## **Conclusion**

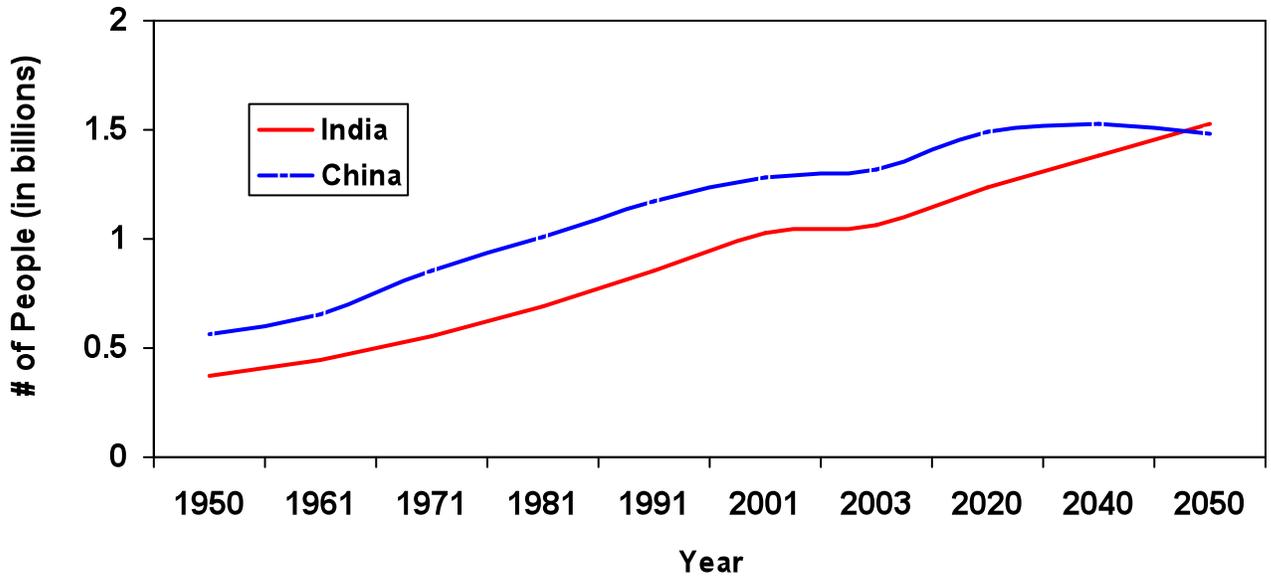
Economic theories such as David Ricardo's work on comparative advantage, as well as Heckscher, Ohlin and Samuelson's work regarding the importance of taking advantage of a nation's relative factor endowments, in regards to the production and subsequent trade of goods, reassure us that it can be in the best interests of a nation to partake in international trade. India chose to avoid this advice and forge her own path towards industrialization and economic development by way of Protectionist trade policies (Import Substitution, elevated Government regulation and quotas, etc...). Unfortunately, this path turned out to be a pitfall, and the people of India have suffered dearly for this mistake. The question now is, has India really learned her lesson, and if so, how determined is the country, both its politicians as well as its people, to bite the proverbial bullet knowing that change won't happen overnight. In fact significant change might not happen this decade or even the next or even the one after that. The only reassuring sentiment is that eventually things will improve, industries will become more competitive, schools, hospitals and highways will be built and people will begin to move out of poverty (this is what Samuelson has taught us). Will India have the political and social patience to endure more tough times with only the hope that things will get better? That is the real question.

What India must do now, to help ensure that change does occur, is: 1) Continue to liberalize trade restrictions by further lifting import tariffs and allowing free trade to work its magic on Indian industrial competitiveness. India must free-up imports, and encourage exports, as imports are crucial to sustain the technology inflow that will ultimately allow domestic industry to become more competitive. 2) Take measures to ensure the Indian environment is seen as hospitable to FDI. This again is a crucial consideration as FDI ultimately allows funds to be generated so that further infrastructural development can take place. This increased infrastructural development will, in turn, allow India to appear more attractive to foreign investors who will then also invest, funding more development and eliciting more investment (it's a cycle). 3) Have faith in the system! Role of the government is most crucial in freeing up the business environment and starting an overhaul of infra structural projects such as roads, utilities

and transportation facilities. Hundreds of successful free trade embracing countries can't be wrong. If India can maintain her current direction of liberalization, globalization and privatization then the positive change in the economy is inevitable. 4) The legal system (and labor laws) of the land is outdated, slow, partly corrupt and extremely inefficient. There have to be drastic steps taken in punishing guilty, establishing right precedents and completing the legal battles promptly. Indian economy with recent unprecedented economic growth has set herself for better days ahead. The actual fulfillment of her dream depends upon the willingness of policy makers to change the things in positive manner as quickly as possible.

**Exhibit 1**

**Population Growth (1950-2005)**



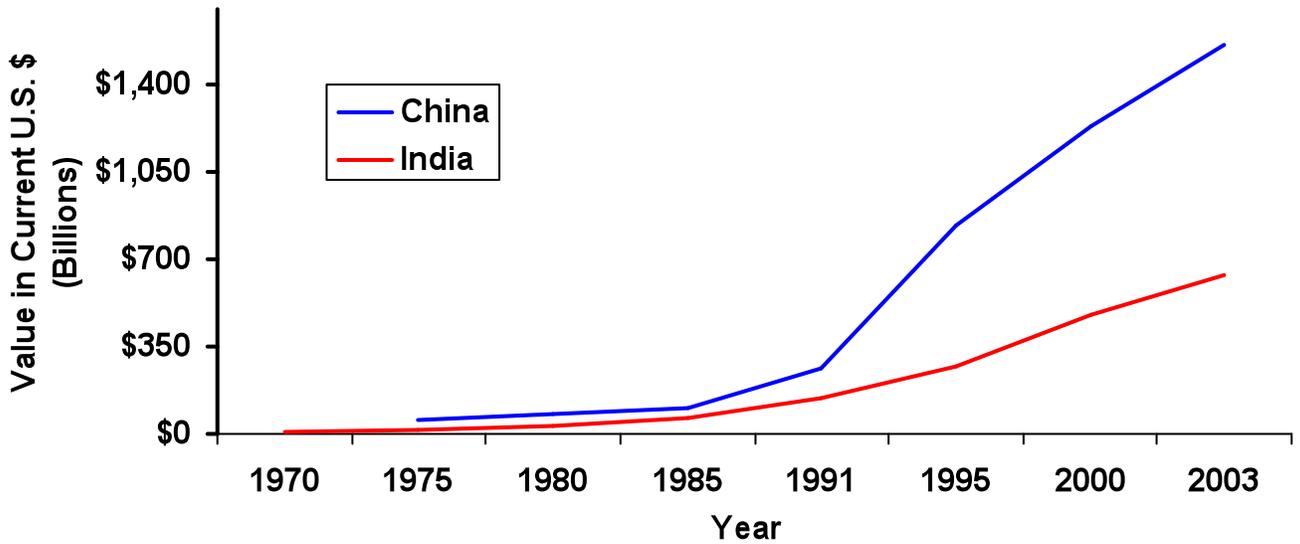
March 2005

<http://www.geohive.com/>

<http://www.census.gov/cgi-bin/ipc/idbsum.pl?cty=CH>

**Exhibit 2**

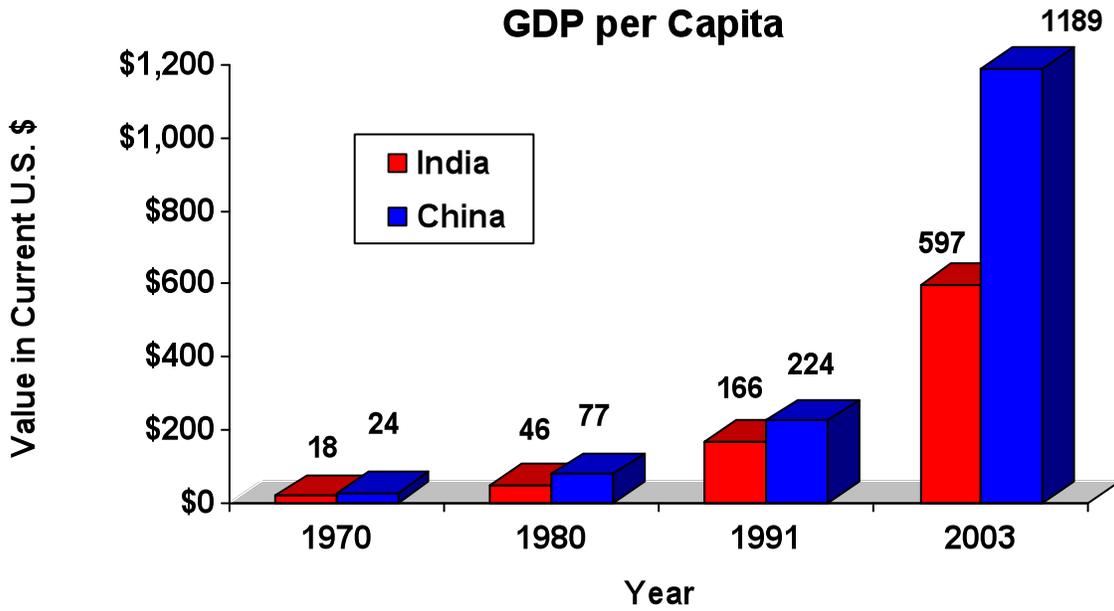
**GDP (Gross Domestic Product)**



*International Financial Statistics Yearbook, March 2005*

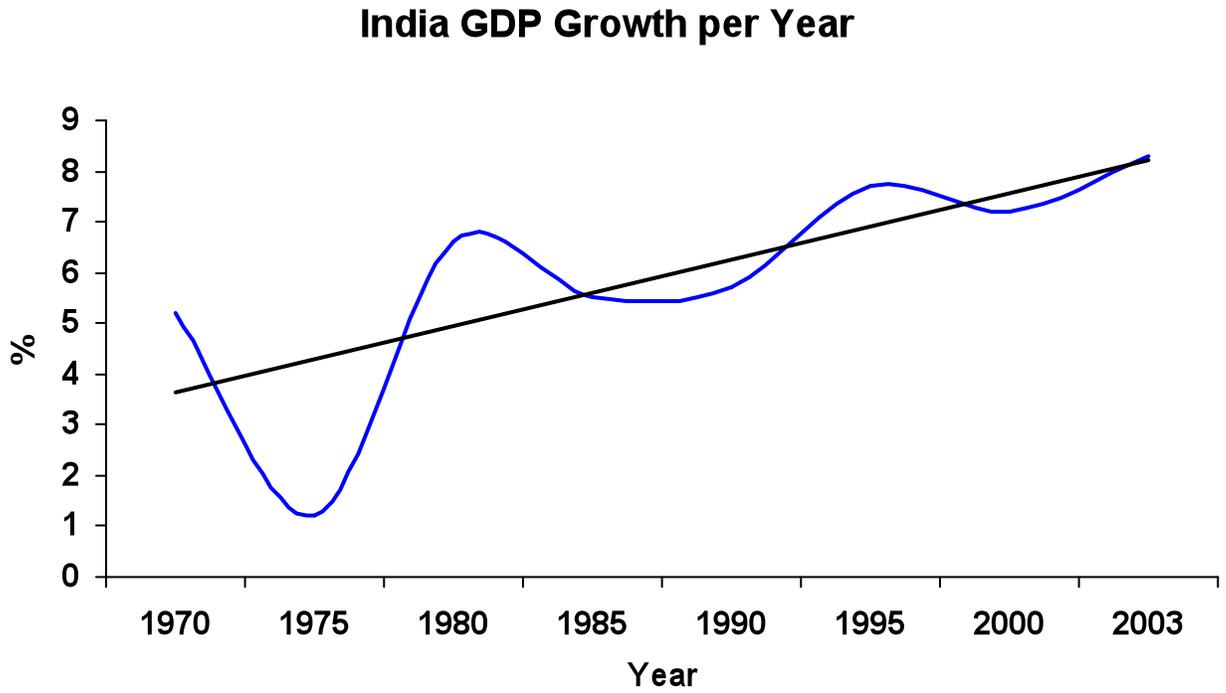
*International Financial Statistics Yearbook vol. LII,*

**Exhibit 3**



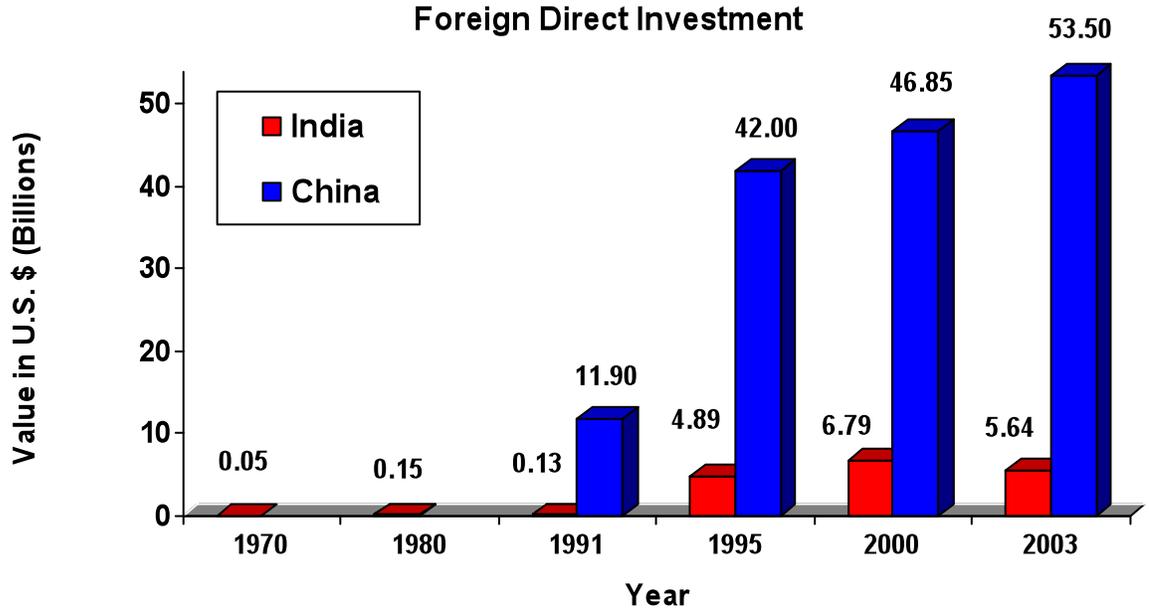
*International Financial Statistics Yearbook vol. LII,  
International Financial Statistics Yearbook, March 2005*

**Exhibit 4**



*International Financial Statistics Yearbook vol. LII,  
International Financial Statistics Yearbook, March 2005*

**Exhibit 5**

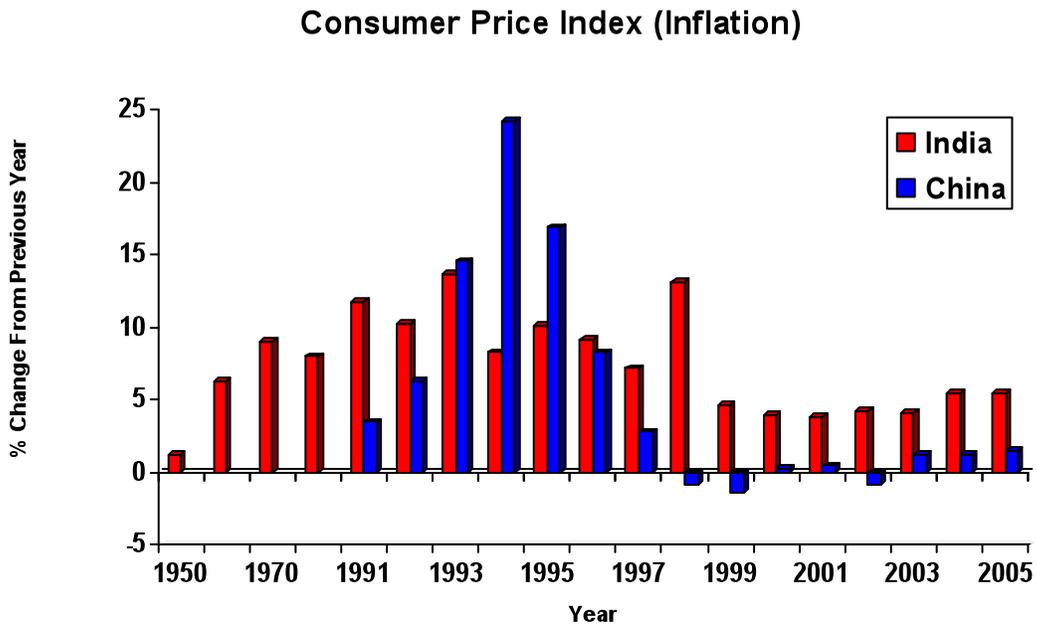


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**Exhibit 6**

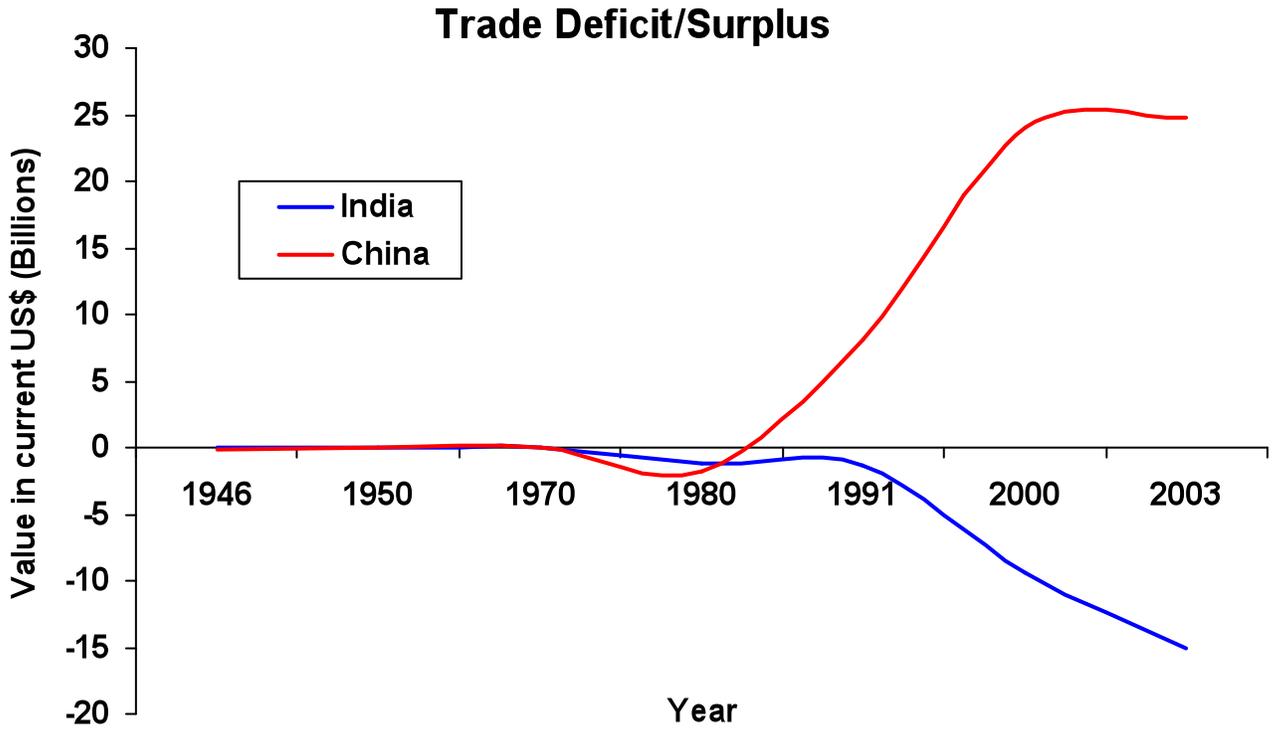


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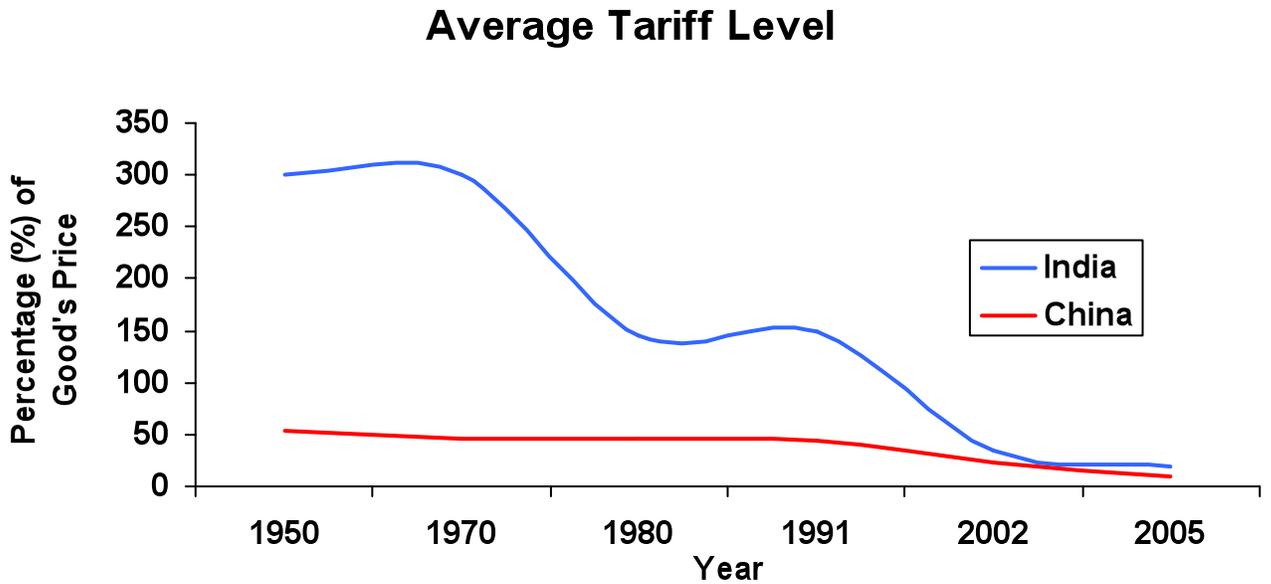
*International Financial Statistics Yearbook, March 2005*

**Exhibit 7**



*International Financial Statistics Yearbook vol. LII,  
International Financial Statistics Yearbook, March 2005*

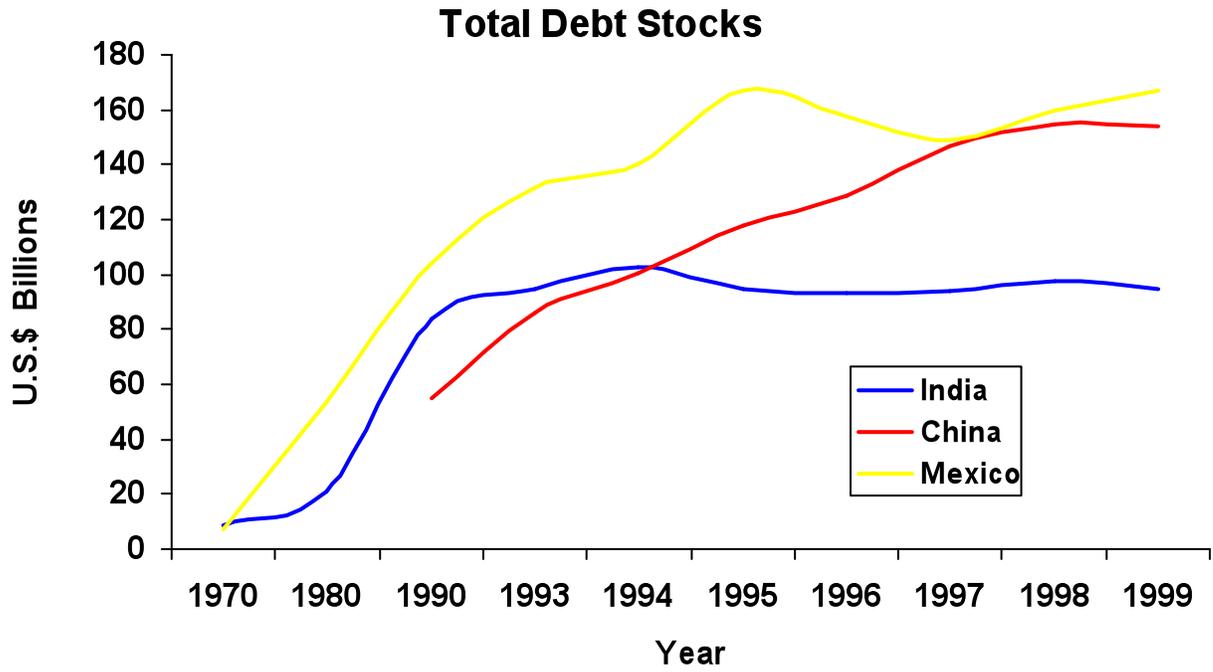
**Exhibit 8**



<http://www.cbw.com/business/chinatax/chinatax3.htm>  
*International Financial Statistics Yearbook vol. LII,*

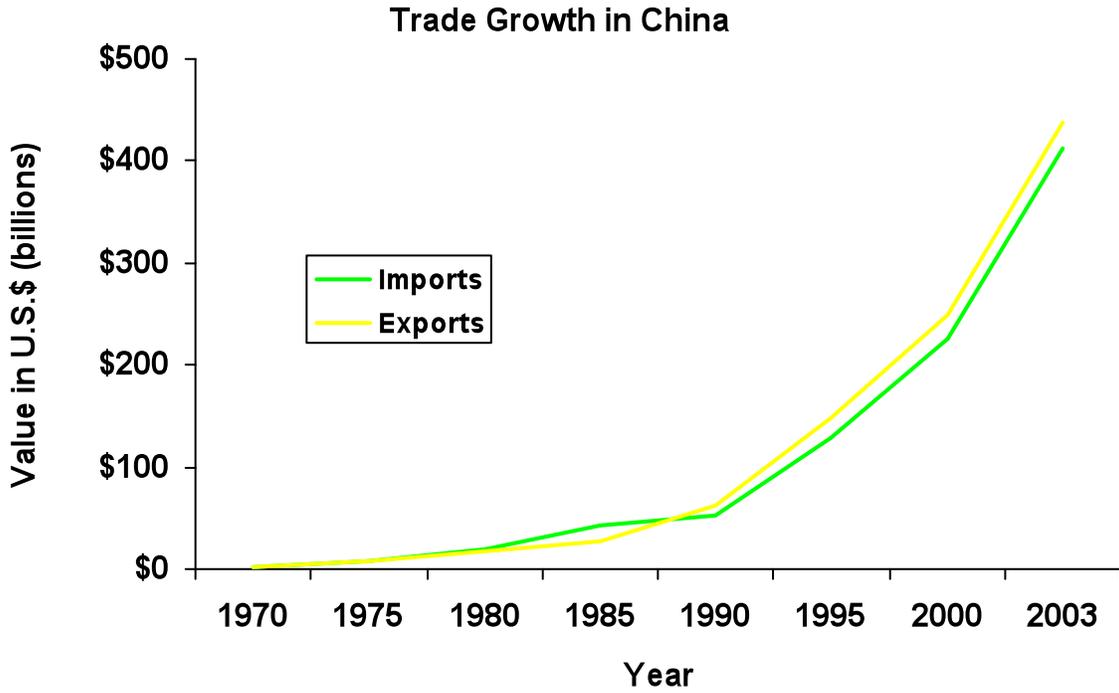
**Exhibit 9**

*International Financial Statistics Yearbook, March 2005*



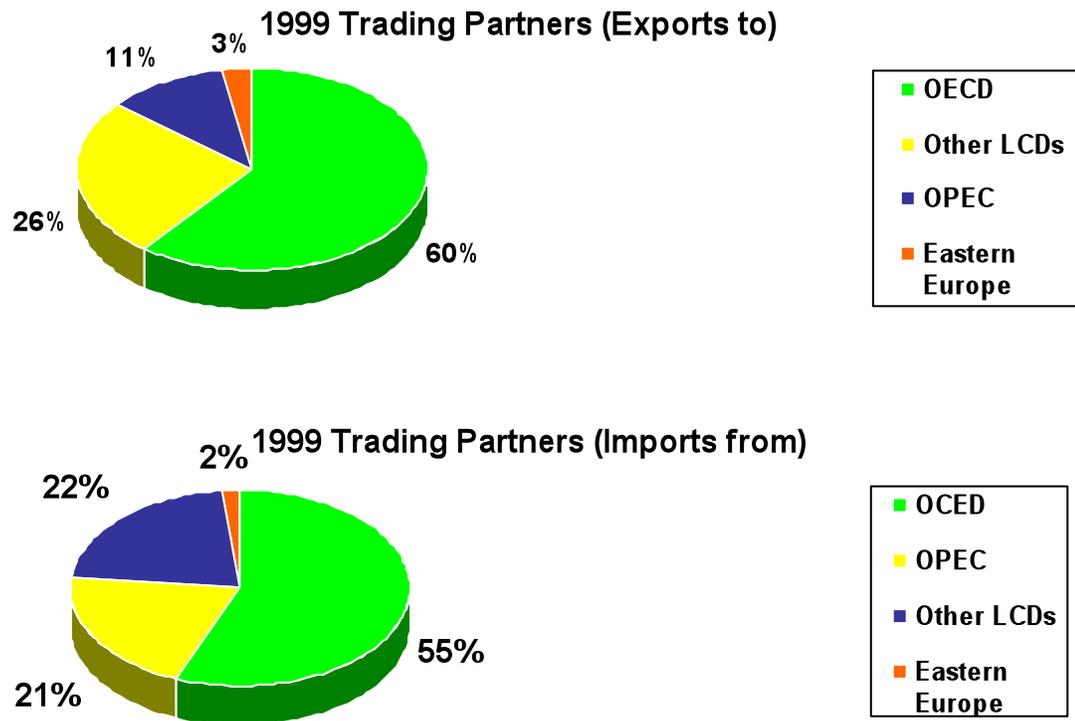
The World Bank; Global Development Finance Statistics 2001

**Exhibit 10**



*International Financial Statistics Yearbook vol. LII,  
International Financial Statistics Yearbook, March 2005*

**Exhibit 11**



*IMF Financial Statistics, The External Sector; Country Profile. India;2000, p.32*

**Exhibit 12**

**India's Main Trading Partners (1999)**

*(Imports from)                      % of Total Value*

<b>U.S.</b>	<b>8.9</b>
<b>Belgium-Luxembourg</b>	<b>7.9</b>
<b>Kuwait</b>	<b>6.2</b>
<b>Japan</b>	<b>5.9</b>
<b>U.K.</b>	<b>5.7</b>
<b>Saudi Arabia</b>	<b>5.6</b>
<b>Germany</b>	<b>4.8</b>

*(Exports to)                              % of Total Value*

<b>U.S.</b>	<b>22.3</b>
<b>U.K.</b>	<b>5.6</b>
<b>Germany</b>	<b>5.3</b>
<b>Japan</b>	<b>5.2</b>
<b>Hong Kong</b>	<b>5.1</b>

*IMF, Direction of Trade Statistics*

**Exhibit 13****(India 1999)****% of Total Exports by Value****% of Total Imports by Value**

Agricultural	<b>17.3</b>		Fuel	17.6
Of which:			Crude Oil & Products	15.4
Cereals	4.4		Edible Oils	4
Fish products	3.1		Fertilisers	2.3
Tea	1.6		Coking Coal	2.2
Oil Meal	1.4		Paper & Newsprint	1.1
Coffee	1.2		Cereals	.6
Spices	1.1		Cashew nuts	.4
Cashew	1.1		Pulses	.2
Fruit & Vegetables	.5		Capital goods	16.6
Tobacco	.4		Of which:	
Raw Cotton	.2		Electrical Machinery	1.1
Minerals	2.6		Transport Equipment	1.5
Of which:			Project goods	4.9
Iron Ore	1.1		Other Machinery	9.1
Processed Minerals	.7		Chemicals	9
Manufactures	<b>77.8</b>		Pearls, Precious & Semi-precious Stones	9
Of which:			Iron & Steel	2.7
Gems & Jewelry	17.5		Non-ferrrous Metals	1.6
Garments	13.2		Precision instruments	1.9
Cotton Textiles	8.2		Unclassified	32
Pharmaceuticals	4.3			
Handicrafts	3.7			
Machinery	3.4			
Metals	3.2			
Leather & Leather goods	2.9			
Transport Equipment	2.2			
Semi-finished Iron and Steel	1.5			
Electronic goods	1.5			
Dyes	1.4			
Leather Shoes	.9			

*Indian Ministry of Finance Statistics*[http://finmin.nic.in/stats\\_data/nsdp\\_sdds/index.html](http://finmin.nic.in/stats_data/nsdp_sdds/index.html)

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