CHAPTER

41 TRENDS IN FOREIGN TRADE AND STRUCTURAL CHANGES

Value of Exports and Imports in the Planning Period
Composition of Foreign Trade
• Composition of Imports • Composition of Exports
Direction of Trade
• Direction of Imports • Direction of Exports
Growth and Structure of India's Foreign Trade Since 1991
• Expansion of Foreign Trade • Changes in Composition of Exports • Changes in Composition of Imports • Direction of Imports in the Post-Rerform Period • Direction of Exports in the Post-Reform Period

In the post-World War II period most of the developing countries that won Independence from colonial powers adopted inward-oriented policies that emphasized import substitution. This was basically due to the export pessimism that prevailed in these economies. Poor growth resulting from such a strategy led to policy reforms in the early 1960s : while one set of countries started giving more incentives to the export sector even as they pursued second-stage import substitution (for instance, Brazil, Argentina and Mexico), another set of countries made a more fundamental shift towards a relatively outward-looking strategy (based on vigorous export promotion) in the early 1960s (for instance, Korea, Singapore and Taiwan). The fast growth registered by these countries prompted many economists and international agencies (most important among them being the IMF and the World Bank) to advocate import liberalisation and export promotion as a panacea for many economic ills facing developing countries like India. Acting upon their advice, the Government of India has opted for a policy of trade liberalisation in recent years. Massive trade policy reforms were announced in 1991 to open up the economy to foreign trade and to 'integrate' the Indian economy into the global economy in the new international order that is taking shape with the setting up of the WTO (World Trade Organisation) in 1995. We have already discussed the trade policy reforms in Chapter 28 on 'Export Import Policy and Trade Liberalisation'.

• In this chapter, we propose to discuss:
• Value of exports and imports in the planning period
• Composition of foreign trade
• Direction of trade
• Growth and structure of India's foreign trade in the post-reform period (*i.e.* the period since 1991).

VALUE OF EXPORTS AND IMPORTS IN THE PLANNING PERIOD

Table 41.1 presents information on the value of foreign trade in India over the period of planning in terms of US dollars. As is clear from this Table, the value of India's exports and imports has increased considerably over the period of planning. From $ 1,269 million in 1950-51, exports rose to $ 8,486 million in 1980-81 and

Table 41.1. Value of Exports and Imports in the Planning Period

(*US $ million*)

Year	*Exports*	*Imports*	*Trade Balance*	*Rate of Change*	
				Exports	*Imports*
(1)	(2)	(3)	(4)	(5)	(6)
1950-51	1269	1273	-4	24.9	-1.5
1960-61	1346	2353	-1007	0.3	16.7
1970-71	2031	2162	-131	8.8	3.5
1979-80	7947	11321	-3374	13.9	36.4
1980-81	8486	15869	-7383	6.8	40.2
1985-86	8904	16067	-7162	-9.9	11.5
1989-90	16612	21219	-4607	18.9	8.8
1990-91	18143	24075	-5932	9.2	13.5
1991-92	17865	19411	-1546	-1.5	-19.4
1992-93	18537	21882	-3345	3.8	12.7
1993-94	22238	23306	-1068	20.0	6.5
1994-95	26330	28654	-2324	18.4	22.9
1995-96	31797	36678	-4881	20.8	28.0
1996-97	33470	39133	-5663	5.3	6.7
1997-98	35006	41484	-6478	4.6	6.0
1998-99	33218	42389	-9171	-5.1	2.2
1999-2000	36822	49671	-12849	10.8	17.2
2000-01	44560	50536	-5976	21.0	1.7
2001-02	43827	51413	-7586	-1.6	1.7
2002-03	52719	61412	-8693	20.3	19.4
2003-04	63843	78150	-14307	21.1	27.3
2004-05	83536	111518	-27982	30.8	42.7
2005-06	103091	149166	- 46075	23.4	33.8
2006-07	126331	190566	-64235	22.5	27.8

Source: (*i*) Government of India, *Economic Survey, 2006-07,* Statement 7.1(B), p. S-79 and (*ii*) Reserve Bank of India, *Annual Report* 2006-07 (Mumbai, September 2007), Appendix Table 49, p. 331.

further to $ 1,26,331 million in 2006-07. Imports during this period rose from $ 1,273 million to $ 15,869 million and further to $ 1,90,566 million. It can also be noted that the country has faced substantial trade deficits during the period of planning. In fact, ***a study of foreign trade data reveals that trade balance was positive in only two years during the entire period 1949-50 to 2006-07. These were the years of 1972-73 and 1976-77 when the country recorded small trade surpluses of $ 134 million and $ 77 million respectively. In all other years, deficits in balance of trade were recorded.*** What is a matter for concern is the fact that the trade deficit has increased significantly over the years. In fact, the average trade deficit in the Sixth Plan (1980-81 to 1984-85) works out at $ 5,985 million per annum and $ 5,669 million per annum during the Seventh Plan (1985- 86 to 1989-90). The year 1990-91 saw a trade deficit of $ 5,932 million as imports rose by 13.5 per cent against a rise of 9.2 per cent registered by exports over the year 1989-90. However, strict import restrictions were imposed in 1991-92, which led to a 19.4 per cent reduction in the value of imports and the trade deficit declined to $ 1,546 million. This sharp cut-back in imports had a decelerating effect on industrial growth and to reverse this trend, massive import liberalisation measures were undertaken in 1992-93. As a result, imports rose considerably and trade deficit touched $ 3,345 million in 1992-93. As can be seen from Table 42.1, the next three years (1993-94 to 1995-96) saw a strong resurgence in export earnings. Although imports also increased yet the overall situation was better and the average trade deficit during the Eighth Plan period (1992-97) was $ 3,456 million per annum- considerably less than the trade deficit recorded in the Sixth and Seventh Plan periods.

During the period of Ninth Five Year Plan (1997-2002), there was marked deterioration. As can be calculated from Table 41.1, the average trade deficit in this Plan was as high as $ 8,412 million. What is more, there were considerable year-to-year fluctuations in trade performance. For instance, two years in this Plan, 1998-99 and 2001-02, registered negative export growth rates while two years, 1999-2000 and 2000-01 registered significant positive growth rates. Rapid increase in exports in 1999-2000 and 2000-01 is explained by recovery in world demand after the Asian crisis and the adoption of various export facilitating measures. The last year of the Ninth Plan, 2001-02, was bad for exports as they registered a decline by 1.6 per cent due to weakening of global demand, poor supply response of exports due to various domestic impediments to export growth, appreciation of the rupee etc.

However, the period of the Tenth Plan has been marked by considerable revival of foreign trade. Exports increased by 20.3 per cent in 2002-03, 21.1 per cent in 2003-04, 30.8 per cent in 2004-05 (highest since 1975-76 and second highest since 1950-51), 23.4 per cent in 2005-06 and by 22.5 per cent in 2006-07. As a result, ***the rate of growth of exports over the Tenth Plan period was, on an average, 24 per cent per annum as against the target of 12.38 per cent per annum.*** According to *Economic Survey, 2006-07,* both external and domestic factors have contributed to this satisfactory performance. Improved global growth and recovery in world trade aided the strengthening of Indian exports. As far as domestic factors are concerned, the opening up of the economy and corporate restructiring has enhanced the competitiveness of Indian industry. There is a far greater export-orientation of domestic manuacturers, and corporate sector has been pursuing new growth strategies in response to economic refoms. Firming up of domestic economic activity, especially in the manufacturing sector, provided a supporting base for strong sector-specific exports. While volume growth dominated export performance till 2002-03, there was a reversal of this trend in 2003-04, with increasing contribution of higher unit value in export performance. Subsequent years witnessed a surge both in terms of volume and unit value. During 2005-06, for exports, while volume increased by a record 45.4 per cent, the unit value increased, by 20.4 per cent.[1] Merchandise imports have also increased considerably during the Tenth Plan. The main reasons have been high international prices of crude oil, lower import tariffs and a buoyant domestic economy (which resulted in higher imports of capital goods, industrial raw materials and intermediate goods). POL (petroleum, oil and lubricants) imports increased by as much as 47.3 per cent in 2005-06 and further by 29.9 per cent in 2006-07. The imports of non-POL goods rose by as much as 28.8 per cent in 2005-06. As a result, the trade deficit increased significantly (see Table 41.1). In fact, ***the trade deficit touched the staggering figure of $ 64,235 million in 2006-07 (the last year of the Tenth Plan)—highest so far. The average trade deficit in Tenth Plan was as high as $ 32,258 million per annum.***

COMPOSITION OF FOREIGN TRADE

By composition of foreign trade of any country we imply the composition of exports and imports. An examination of the composition of foreign trade of a country enables us to analyse the progress of that country and the rate and speed of structural changes operating in it. For example, if we find on scrutiny that the country in question imports foodgrains and raw materials but exports finished goods, machinery, and capital equipment, we can safely conclude that it has reached a high level of economic development. On the other hand, if it exports primary commodities like jute, tea, raw cotton, sugar, etc., but imports capital equipment and machinery, finished goods, etc., we can conclude that the country is an underdeveloped one. The speed with which such a country changes its pattern of trade (leading to a percentage decline in imports of manufactured products and percentage increase in the exports of such products) is sometimes taken by some economists as an indication of the pace of development in the country .

Before the advent of planning in India, main exports were primary goods like jute, tea, cotton, hides and skins, manganese ore, mica, etc., while manufactured products constituted the bulk of imports. During the planning period, the process of industrialisation and economic development has induced a number of changes in the composition of foreign trade, as would be clear from the discussion below.

Composition of Imports

In 1947-48, the main items of imports in India (in order of importance were: machinery of all kinds; oils (vegetable, mineral and animal); grains, pulses and flour; cotton, raw and waste; vehicles (excluding locomotives); cutlery, hardware, implements and instruments; chemicals, drugs and medicines; dyes and colours; other yarns and textile fabrics; paper, paper board and stationery; and metals other than iron and steel and manufactured. These imports together constituted more than 70 per cent of all imports.

The initiation of the planning process in the country in 1951~52, and more specifically the beginning of the Second Five Year in 1956-57 brought about a considerable change in the composition of imports. The Second Plan (based on the Mahalanobis Model) introduced a programme of industrialisation with heavy emphasis on the development of capital goods and basic industries. As a result, it became necessary to import capital equipment in large quantities. After some years, spare parts, materials and machinery had to be imported in substantial quantities to keep the equipment in working order. Thus 'maintenance imports' entered into the import structure of the country in a big way. The composition of imports since 1960-61 is given in Table 41.2.

For convenience, imports of the country have been divided into four broad groups: *(i)* Food and live animals chiefly for food, *(ii)* Raw materials and intermediate manufactures, *(iii)* Capital goods and *(iv)* Other goods. The table shows that the total imports in 1960-61were $ 2,353 million of which the share of the above groups was 19.1,47.0,31.7 and 2.2 per cent respectively. There have been significant changes in the relative importance of these groups over time. The most important change is that the imports of food and live animals have declined sharply. This is due to the decline in the imports of cereals and cereal preparations. For instance, from 16.1 per cent in 1960-61, the share of cereals and cereal preparations fell to almost zero per cent in 2005-06. On the other hand, the share of raw materials and intermediate manufactures has increased considerably primarily due to a sharp rise in the import of petroleum oil and lubricants, fertilisers, and pearls and precious stones. Capital goods had accounted for about one-third of import expenditure in 1960-61, which fell to a little more than one-fifth in 1996-97. In 2005-06, the share of capital goods in total imports was 15.8 per cent.

Important facts regarding the composition of different import items are as follows:

1. There has been a substantial rise in the import expenditure on POL (petroleum, oil and lubricants) imports. For example, POL imports accounted for only 6.1 per cent of import expenditure in 1960-61 and 8.3 per cent in 1970-71. This increased dramatically to 41.9 per cent in 1980-81. This sharp increase was due to two hikes in oil prices in 1970s—one in 1973-74 when the Oil and Petroleum Exporting Countries (OPEC) raised the price of oil from around $ 2.50 to $ 3.00 per barrel to $11.65 per barrel and the other in 1978-79 when the price of oil was raised sharply to $ 35.00 per barrel. The period of 1980s was marked by substantial increase in domestic oil production on the one hand and a softening of international oil prices on the other hand. As a result, the share of POL imports in total import expenditure declined considerably to 25 per cent in 1991-92. In percentage terms, the share of POL imports in total imports varied between 25.0 per cent to 30 per cent during 1990s. ***In 2005-06, imports of POL were $ 43,963 million which was 29.5 per cent of total import expenditure.***

2. Since 1999-2000, data on imports of gold and silver have become available as their imports are now channelised through the official routes. As a result, data on imports of non-ferrous metals in Table 41.2 for the year 2004-05 and 2005-06 include the data on imports of gold and silver also. In 2005-06 imports of non-ferrous metals stood at $13,162 million which was 8.8 per cent of total import expenditure. Thus, ***imports of non-ferrous metals now occupy second position in total import expenditure.***

3. Import expenditure on 'non-electrical machinery, apparatus and appliances' rose considerably from $ 341 million in 1970-71 to $11,086 million in 2005-06. In percentage terms, its share was 15.8 per cent in 1970-71 while in 1980s and 1990s, it has varied between 8 to 12 per cent. In 2005-06, the share of 'non-electrical machinery, apparatus and appliances' in total import expenditure was 7.4 per cent.

4. Due to the increasing demand of the gems and jewellery industry (which has emerged as an important export earning industry) the imports of 'pearls, precious and semi-precious stones' have increased significantly. In fact, this item accounted for 11.3 per cent of import expenditure in 1993-94 and occupied the second place. Imports of 'pearls, precious and semi-precious stones' in 2005-06 stood at $ 9,134 million which was 6.1 per cent of total import expenditure.

5. Because of increasing domestic demand, edible oils also have had to be imported on a considerable scale in certain years. For example, in 1987-88, edible oils worth $ 969 million had to be imported. This was 4.4 per cent of total import expenditure in that year. However, as the production of edible oils increased in the country, the imports declined. In 1989-90, imports of edible oils fell to only $ 127 million. Nevertheless, due to pressures of domestic demand, substantial imports of edible oils had to be resorted to during certain years in the 1990s. For instance, in 1999-2000, imports of edible oils were as high as $1,857 million accounting for 3.7 per cent of total import expenditure. In 2005-06, imports of edible oils were of $ 2,024 million which was 1.4 per cent of total import expenditure.

6. Despite increasing domestic production of iron and steel, substantial quantities continue to be imported as domestic production has failed to keep pace with the rising demand. While in absolute terms, the imports

TABLE 41.2. Composition of Indian Imports

Commodities	1960-61		1970-71		1980-81		1990-91		2004-05		2005-06	
	$ million total	**% of**	$ million total	% of	$ million total	% of	$ million total	% of	$ million total	% of	$ million total	% of
1. **Food and live animals chiefly for food**	**449**	**19.1**	**321**	**14.8**	**481**	**3.0**	**N.A.**	**N.A.**	**N.A.**	**N.A.**	**N.A.**	**NA.**
of which:												
Cereals and cereal preparations	380	16.1	282	13.0	127	0.8	102	0.4	19	0.0	36	0.0
2. **Raw materials and intermediate manufactures**	**1105**	**47.0**	**1176**	**54.4**	**12341**	**77.8**	**N.A.**	**N.A.**	**N.A.**	**N.A.**	**N.A.**	**N.A.**
of which:												
(a) Edible oils	8	0.4	31	1.4	857	5.4	182	0.8	2465	2.2	2024	1.4
(b) Petroleum oils and lubricants	145	6.1	180	8.3	6656	41.9	6028	25.0	29844	26.8	43963	29.5
(c) Fertilisers	27	1.1	113	5.3	1034	6.5	984	4.1	1249	1.1	1991	1.3
(d) Iron and Steel	258	11.0	194	9.0	1078	6.8	1178	4.9	2670	2.4	4572	3.1
(e) Chemical elements and compounds	82	3.5	90	4.2	453	2.8	1276	5.3	6519	6.2	8037	5.7
(f) Pearls and precious stones	2	0.1	3.3	1.5	527	3.3	2083	8.7	9423	8.4	9134	6.1
(g) Non-ferrous metals*	99	4.2	158	7.3	6.4	3.8	614	2.5	12460	11.2	13162	8.8
3. **Capital goods**	**747**	**31.7**	**534**	**24.7**	**2416**	**15.2**	**5833**	**24.2**	**14476**	**13.0**	**23522**	**15.8**
of which :												
(a) Non-electrical machinery**	426	18.1	341	15.8	1377	8.7	2363	9.8	7438	6.7	11086	7.4
(b) Electrical machinery**	120	5.1	93	4.3	328	2.1	949	3.9	1195	1.1	1504	1.0
(c) Transport equipment	151	6.4	88	4.1	597	3.8	931	3.9	4327	3.9	8838	5.9
4. **Others (unclassified)**	**52**	**2.2**	**131**	**6.1**	**631**	**4.0**	**N.A.**	**N.A.**	**N.A.**	**N.A.**	**N.A.**	**N.A.**
Total	**2353**	**100.0**	**2162**	**100.0**	**15869**	**100.0**	**24075**	**100.0**	**111518**	**100.0**	**149166**	**100.0**

* Since 1999-2000 data on imports of gold and silver are available (because imports of gold and silver are now channelised through the official routes). Therefore, the data on 'non-ferrous metals' for the years 2004-05 and 2005-06 include the data on gold and silver also.

**From the year 1991-92 onwards, non-electrical machinery and electrical machinery exclude electronic goods.

Source : Government of India, *Economic Survey, 2006-07,* Statement 7.2 (A), pp. S-80 to S-82.

of iron and steel rose from $ 194 million in 1970-71 to $1,178 million in 1990-91, in percentage terms they have more or less consistently fallen (from 9.0 percent in 1970-71 to 4.9 per cent in 1992-93). In 2005-06, their share in import expenditure way only 3.1 per cent.

7. Import expenditure on fertilizers and fertilizer materials increased considerably from $ 113 million in 1970-71 to $ 1,683 million in 1995-96. This is due to the increasing requirement of fertilizers for the implementation of the new agricultural strategy and also due to the increasing prices of fertilizers in the international market. In percentage terms, the share of fertilizers in total imports has varied between 3.5 to 6 per cent over the period 1970-71 to 1995-96. In 1995-96, its share in total import expenditure stood at 4.6 per cent. However, subsequently, the share of fertilizers in total import expenditure declined and stood at only 1.3 per cent in 2005-06.

8. Foodgrains have had to be imported on a considerable scale for a number of years to meet the domestic requirements of the economy. Their share in imports stood at as much as 16 per cent in 1960-61. Despite green revolution and consequent increases in foodgrains production and productivity, imports of foodgrains constituted 13 per cent of total imports in 1970-71 and as much as 25.5 per cent in 1975-76 *(i.e.* about one fourth). In later years, due to substantial increase in foodgrains production at home, the imports fell steeply. However, in certain years foodgrains were imported on a considerable scale to replenish depleted foodstocks. For instance, foodgrains worth $ 334 million were imported in 1992-93. After that they again fell considerably. In 2005-06, imports of foodgrains were merely $ 36 million.

Composition of Exports

Composition of Indian exports is presented in Table 41.3. A clear trend over the years has been a decline in the importance of agriculture and allied products and a substantial increase in the importance of manufactured products. For instance, the share of agriculture and allied products in total exports declined considerably from 44.2 per cent in 1960-61 to 10.2 per cent in 2005-06 while that of manufactured products increased from 45.3 per cent to 73.6 per cent over the same period. This clearly depicts the changing production structure of the economy and the march from an underdeveloped, backward, primary goods dependent economy to a more vibrant industrial economy.

Important points that emerge from Table 41.3 regarding different export items are as follows:

1. The most important export item in 1960-61 was jute and it contributed 21 per cent (or a little more than *one fifth)* of total export earnings. Since then its share has continuously declined (to 12.4 per cent in 1970-71 and 0.3 per cent in 2005-06).

2. The second most important export item in 1960-61 was tea and it contributed 19.3 per cent (*i.e.* almost *one fifth*) of total export earnings. Its share has also declined consistently to 9.6 per cent in 1970-71 and 0.4 per cent in 2005-06. During recent years it has contributed more earnings as compared to jute.

3. Consequent upon the programmes of industrialisation initiated during the planning period, the exports of engineering goods rose substantially. From $ 46 million in: 1960-61, exports of engineering goods rose to $ 261 million in 1970-71 and further to $ 21,315 million in 2005-06. As a result, their share in India's export earnings rose from 3.4 per cent in 1960-61 to 20.7 per cent in 2005-06 (*i.e.,* ***one-fifth of total export earnings***). During most of the recent years, engineering goods have occupied the second or third place in India's export earnings. However, in 2004-05 and 2005-06 they occupied the first place followed by gems and jewellery.

4. As is clear from Table 41.3, exports of gems and jewellery have recorded a spectacular increase. From $ 96 million in 1970-71 (representing 4.7 per cent of total export earnings) the exports of gems and jewellery rose to $15,529 million in 2005-06 (representing 15.1 per cent of total export earnings). In 2005-06, gems and jewellery occupied the *second place in* India's export earnings behind engineering goods.

5. The results of industrialisation are also expressed through increases in the exports of chemicals and allied products. From $ 39 million in 1970-71, the exports of chemicals and allied products rose to $ 11,935 million in 2004-05. In 2005-06, they contributed 11.6 per cent of total export earnings and occupied *third* place.

6. Export of readymade garments has emerged as an important foreign exchange earner in recent years. In 1970-71 export of readymade garments was only $ 2 million. In 2005-06 this had risen to $ 8,572 million (*i.e.* 8.3 per cent) of total export earnings. In recent years, readymade garments have occupied either second or third place in India's export earnings. In 2005-06 they occupied *fourth* place.

7. Fifth position in export earnings in 2005-06 was occupied by cotton yarn, fabrics, made-ups etc. with a share of 3.8 per cent ($ 3,943 million out of a total of $ 1,03,091 million).

TABLE 41.3. Composition of Indian Exports

Commodities	1960-61		1970-71		1980-81		1980-91		2004-05		2005-06	
	$ million total	% of	$ million total	% of	$ million total	% of	$ million total	% of	$ million total	% of	$ million total	% of
1. **Agriculture and allied products**	**596**	**44.2**	**644**	**31.7**	**2601**	**30.6**	**3521**	**19.4**	**8809**	**10.5**	**10549**	**10.2**
of which:												
(a) Tea and mate	260	19.3	196	9.6	538	6.3	596	3.4	238	0.5	359	0.4
(b) Cashew kernels	40	3.0	76	3.7	177	2.1	249	1.4	554	0.7	586	0.6
(c) Rice	—	—	7	0.3	283	3.3	257	1.4	1507	1.8	1405	1.4
(d) Fish and fish preparations	10	0.8	40	2.0	274	3.2	535	2.9	1440	1.7	1589	1.5
2. **Ores and Minerals (excluding coal)**	**109**	**8.1**	**217**	**10.7**	**523**	**6.2**	**834**	**4.6**	**4568**	**5.5**	**5361**	**5.2**
of which:												
Iron Ore	36	2.6	155	7.6	384	4.5	585	3.2	3277	3.9	3801	3.7
3. **Manufactured goods**	**610**	**45.3**	**1021**	**50.3**	**4738**	**55.8**	**13229**	**72.9**	**62023**	**74.3**	**74199**	**72.0**
of which:												
(a) Cotton yarn, fabrics, made-ups etc.	136	10.1	188	9.2	516	6.1	1170	6.4	3450	4.1	3943	3.8
(b) Readymade garments	2	0.1	39	1.9	696	8.2	2236	12.8	6562	7.9	8572	8.3
(c) Jute manufactures	283	21.0	252	12.4	417	4.9	166	0.9	276	0.3	298	0.3
(d) Leather and Leather manufactures	59	4.4	106	5.2	493	5.8	1449	8.0	2422	2.9	2691	2.6
(e) Gems and jewellery	2	0.1	59	2.9	782	9.2	2924	16.1	13762	16.5	15529	15.1
(f) Chemicals and allied products	15	1.1	39	1.9	284	3.3	1176	6.5	10172	12.2	11935	11.6
(g) Engineering goods	46	3.4	261	12.9	1045	12.3	2158	11.9	17274	20.7	21315	20.7
4. **Others**	**31**	**2.4**	**149**	**7.3**	**624**	**7.4**	**31**	**0.2**	**8136**	**9.7**	**12982**	**12.6**
Total	**1346**	**100.0**	**2031**	**100.0**	**8486**	**100.0**	**18143**	**100.0**	**83536**	**100.0**	**103091**	**100.0**

Source : Government of India, *Economic Survey, 2006-07*, Statement 7.3 (A), pp. S-84 to S-86.

8. Sixth place in export earnings in 2005-06 was occupied by iron ore. In 2003-04, exports of iron ore were just $ 1,126 million (which was 1.8 per cent of export earnings). They rose considerably to $ 3,277 million in 2004-05 and $ 3,801 million in 2005-06 (which is 3.7 per cent of export earnings). The main reason for this sudden jump has been the increased demand for iron ore made by Chinese iron and steel industry.

9. Seventh place in export earnings in 2005-06 was occupied by leather and leather manufactures (including footwear). In fact, they contributed $ 2,691 million in 2005-06 *i.e.* 2.6 per cent of total export earnings.

10. 'Fish and fish preparations' increased their share in export earnings from 2.0 per cent in 1970-71 to 4.3 per cent in 1994-95. In 1995-96, however, their share fell to 3.2 per cent. The exports of 'fish and fish preparations' stood at $ 1,589 million in 2005-06 which was 1.5 per cent of export earnings.

11. In recent years, substantial quantities of rice have been exported. For instance, export earnings from rice stood at $ 907 million in 1997-98, $ 1,493 million in 1998-99 and $ 721 million in 1999-2000. In 2005-06, exports of rice stood at $ 1,405 million which was 1.4 per cent of total export earnings.

DIRECTION OF TRADE

In the pre-Independence period, the direction of India's foreign trade was determined not according to the comparative cost advantages of India but by the colonial relations between India and Britain. In other words, it was Britain that decided from which countries India could import its requirements and to which countries it could export its products. Naturally, a major part of India's trade was either directly with Britain or its colonies or allies. This pattern continued for some years after Independence as well since India had not till then explored the possibilities of developing trade relations with other countries of the world. For example, the combined share of U.K. and U.S.A. in India's export earnings was 42 per cent in 1950-51. Their share in India's import expenditure was as much as 39.1 per cent in the same year. With other capitalist countries like France, Germany, Italy, Japan, etc. India either did not have trade relations at all or they were very insignificant. As political and diplomatic contacts developed with other countries, economic relations also made a headway. Thus new vistas for developing trade relations with other countries opened up. The situation has changed very much since, and now after five and a half decades of planning, the trading relations exhibit marked changes. The diversification in trade relations has reduced the vulnerability of the economy to outside political pressures.

Direction of Imports

For purposes of studying direction of trade, India's trading partners have been divided into five major groups in Table 41.4 : OECD, OPEC, Eastern Europe, Developing Nations and Others. First consider imports. As is clear from the table, the importance of OECD as a group has declined considerably over the period 1960-61 to 2006-07. The share of this group in India's import expenditure was 78 per cent in 1960-61 which fell to 36.5 per cent in 2006-07. The share of the group of oil exporting countries (OPEC) increased considerably over time. From 4.6 per cent in 1960-61, the share of this group in India's imports increased to 27.8 per cent in 1980-81 and stood at 22.5 per cent in 1999-2000. This shows that between one-fourth and one-fifth of India's import expenditure has been due to heavy dependence on this group of countries for meeting its import requirements of crude oil. However, there was a drastic change in later years. The share of OPEC in India's import expenditure fell to a mere 5.7 per cent in 2002-03 and stood at 7.7 per cent in 2005-06. On the other hand, as can be seen from Table 41.4, the share of 'other countries' (the residual category) rose significantly to 27.4 per cent in 2004-05 and further to 31.2 per cent in 2005-06. This suggests a change in sourcing of oil imports away from the OPEC region towards residual category countries. However, there was a drastic change in 2006-07 and the share of OPEC in India's import expenditure shot up to 29.4 per cent as oil imports from this region increased markedly. As trade relations expanded with socialist countries, the share of Eastern Europe in imports also increased considerably from 3.4 per cent in 1960-61 to 10.3 percent in 1980-81 and stood at 7.8 per cent in 1990-91. Due to the setback to communist regimes in this block in recent years (and particularly, due to the disintegration of USSR), the share of Eastern Europe in imports declined considerably and was only 2.4 per cent in 2006-07. As is clear from the Table, developing nations (particularly of Asia) have increased their share considerably in India's imports. They accounted for 31.3 per cent of India's import expenditure in 2006-07. Important facts regarding India's country-wise imports are as under:

In the year 1950-51, the share of U.K in India's imports was 20.8 per cent and that of U.S.A. was 18.3 per cent. Thus the combined share of these two countries was 39.1 per cent. This reflected the colonial heritage of the country. Within a decade, the picture started showing some changes. New trading partners like West

TABLE 41.4. Direction of India's Trade

	Imports						*Exports*					
	1960-61	*1970-71*	*1980-81*	*1990-91*	*2005-06*	*2006-07*	*1960-61*	*1970-71*	*1980-81*	*1990-91*	*2005-06*	*2006-07*
I. OECD	**78.0**	**63.8**	**45.7**	**54.0**	**32.73**	**36.5**	**66.1**	**50.1**	**46.6**	**53.5**	**44.2**	**41.2**
of which:												
1. EU	37.1	19.6	21.0	29.4	15.7	17.6	18.4	21.6	27.5	21.8	21.6	20.4
(*a*) Belgium	1.4	0.7	2.4	6.3	3.3	2.2	0.8	1.3	2.2	3.9	2.8	2.7
(*b*) Germany	10.9	6.6	5.5	8.0	4.1	6.6	3.7	2.1	5.7	7.8	3.4	3.2
(*c*) U.K.	19.4	7.8	5.8	6.7	2.7	2.2	26.8	11.1	5.9	6.5	5.0	4.4
2. USA	29.2	27.7	12.9	12.1	5.5	6.6	16.0	13.5	11.1	14.7	16.7	14.9
3. Switzerland	–	0.7	1.0	1.1	4.6	4.8	–	0.5	1.6	1.2	0.5	0.4
4. Japan	5.4	5.1	6.0	7.5	2.5	2.4	3.4	13.3	8.9	9.3	2.4	2.2
II. OPEC	**4.6**	**7.7**	**27.8**	**16.3**	**7.7**	**29.4**	**4.1**	**6.4**	**11.1**	**5.6**	**14.8**	**16.3**
of which:												
1. UAE	–	–	2.8	4.4	3.0	5.0	–	0.4	2.3	2.4	8.4	9.5
2. Indonesia	–	–	–	0.3	2.1	2.2	–	–	–	0.6	1.3	1.6
3. SaudiArabia	1.3	1.5	4.3	6.7	1.1	7.0	0.9	2.5	1.7	1.3	1.8	2.0
III. Eastern Europe	**3.4**	**13.5**	**10.3**	**7.8**	**2.6**	**2.4**	**7.0**	**21.0**	**22.1**	**17.9**	**1.9**	**2.0**
of which:												
1. Russia*	1.4	6.5	8.1	5.9	1.4	1.1	4.5	13.7	18.3	16.1	0.7	0.7
IV. Developing Nations	**11.8**	**14.6**	**15.7**	**18.6**	**25.8**	**31.3**	**14.8**	**19.8**	**19.2**	**17.1**	**38.7**	**40.1**
of which:												
Asia	5.7	3.3.	11.4	14.0	21.0	24.8	6.9	10.8	13.4	14.4	30.1	29.7
(*a*) China	–	–	–	0.1	7.5	9.1	–	–	–	0.1	6.5	6.6
(*b*) Hong Kong	–	0.1	0.3	0.7	1.5	1.3	–	1.1	2.1	3.3	4.3	3.7
(*c*) South Korea	–	–	1.1	1.5	3.0	2.5	–	–	0.7	1.0	1.8	2.0
(*d*) Singapore	–	–	3.4	3.3	2.3	2.9	–	–	1.6	2.1	5.4	4.8
(*e*) Malaysia	–	0.4	1.6	2.3	1.7	2.8	–	0.8	0.8	0.8	1.1	1.0
V. Others	**2.2**	**0.5**	**0.5**	**0.0**	**31.2**	**0.4**	**8.0**	**2.6**	**1.0**	**2.9**	**0.4**	**0.4**
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

*Refers to former USSR before 1992-93.

Source : Computed from (1) Reserve Bank of **India**, ***Report on Currency and Finance,*** Various issues, and (2) Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2006-07* (Mumbai, 2007), **Table 139, pp.** 227-29.

Germany, Canada and U.S.S.R. emerged. There was a change in the relative position of U.K. and U.S.A. as well, with the latter pushing down the former to the *second* place. Excepting a year or two U.S.A. has continuously maintained the *first position* thereafter. ***During the planning period as a whole, India has obtained maximum imports from U.S.A., the reason being that India has imported large scale quantities of capital goods, intermediate products and foodgrains (under P. L. 480 agreement) from that country.*** With the expansion of trading relations with Japan, West Germany and U.S.S.R., the dependence on the U.K. declined considerably. Thus the share of U.K. in Indian imports declined from 19.4 per cent in 1960-61 to 2.2 per cent in 2006-07. On the other hand, the share of Japan increased from 1.5 per cent in 1950-51 to 5.4 per tent in 1960-61 and further to 7.5 per cent in 1990-91. However, thereafter, it decreased in percentage terms to 6.5 per cent in 1995-96 and 2.4 per cent in 2006-07.

Another significant development was the expansion in trading relations with the socialist countries especially the erstwhile U.S.S.R. Imports from U.S.S.R. were negligible in 1950-51. In 1960-61 they amounted to a meagre Rs.16 crore. However, thereafter, they increased rapidly thanks to bilateral trade agreements with that country. In 1984-85, the share of U.S.S.R. was 10.4 per cent and it displaced U.S.A. from the first place. The picture changed thereafter. In 1985-86, U.S.A. was first, Japan second and U.S.S.R. third. In 1990-91, with a share of 12.1 per cent, U.S.A. occupied the first place. It was followed by Germany with a share of 8.0 per cent (the figure is for unified Germany). Japan had the third position (share 75 per cent), U.K and Saudi Arabia shared the fourth position with a share of 6.7 per cent each, Belgium had the fifth position (share 6.3 per cent) while U.S.S.R. had the sixth position (share 5.9 per cent). With the disintegration of U.S.S.R., the direction of imports changed markedly. ***In 2006-07, China occupied the first position in India's imports (share 9.1 per cent), followed by Saudi Arabia (share 7.0 per cent), Germany (share 6.6 per cent), USA (share 6.6 per cent),[2] UAE (share 5.0 per cent), Switzerland (share 4.8 per cent), Singapore (share 2.9 per cent) and Malaysia (share 2.8 per cent).***

Direction of Exports

As is clear from Table 41.4, OECD group accounts for a major portion of India's exports. The share of this group in 1960-61 was 66.1 per cent and in 2006-07 was 41.2 per cent. Almost 50.0 per cent of these exports were accounted for by the EU countries in 2006-07. The OPEC group accounted for 4.1 per cent of exports in 1960-61 and its share in 2006-07 rose to 16.3 per cent. Most significant was the rapid increase in exports to the countries of Eastern Europe particularly U.S.S.R. For instance, Eastern Europe accounted for 7.0 per cent of export earnings iI) 1960-61 and its share shot up to 22.1 per cent in 1980-81. During recent years, exports to this group have suffered a setback due to marked political upheavels in these countries and the disintegration of the U.S.S.R. In 2006-07 the share of Eastern Europe in total exports had slumped to a mere 2.0 per cent. Developing nations of Africa, Asia and Latin America accounted for 40 per cent of India's export earnings in 2006-07. Most important in this group have been the countries of Asia. In fact, exports to Asian countries accounted for 29.7 per cent of India's total export earnings in 2006-07. Thus, ***countries of Asia now account for almost 30 per cent of India's export earnings.*** Important facts regarding India's country-wise exports are as under:

At the start of the planning process in India in 1950-51, the share of U.K. in India's total exports was as high as 23.3 per cent. This came down substantially to 11.1 per cent in 1970-71 and 4.4 per cent in 2006-07. The second position in 1950-51 and 1960-61 was occupied by U.S.A., its share in India's exports being 19.3 per cent and 16.0 per cent in these years respectively. In fact, India was dependent for 42.6 per cent and 44.8 per cent of its export earnings on U.K. and U.S.A. in 1950-51 and 1960-61 respectively. Other capitalist countries and socialist countries purchased Indian goods on a very small scale. However, after 1960-61, India's trading relations with these countries expanded at a very rapid pace. Thus U.S.S.R. which purchased only Rs. 11 crore worth of goods from India in 1950-51 increased its purchases to Rs. 210 crore in 1970-71 and Rs. 2,006 crore in 1985-86. In fact, it occupied the *first* place in India's export earnings in that year followed by U.S.A., Japan, U.K. and West Germany in that order. Thereafter, the position changed again and U.S.A. occupied the *first* position in 1986-87, 1987-88, 1988-89 and 1989-90. The *second* position was occupied by U.S.S.R. in all these years while the *third* position was occupied by Japan. In 1990-91 U.S.S.R. with a share of 16.1 per cent in India's export earning occupied the first position with U.S.A. (share 14.7 per cent) occupying the second position. Japan with a 9.3 per cent share occupied the third position. The position changed markedly thereafter due to the disintegration of the U.S.S.R. As is clear from Table 41.4, exports to Russia accounted for only 0.7 per cent of export earnings in 2006-07. ***In 2006-07, U.S.A. with a share of 14.9 per cent occupied the top position. It was followed by U.A.E. (share 9.5 per cent), China (share 6.6 per cent), Singapore (share***

4.8 per cent), UK (share 4.4 per cent), Hong Kong (share 3.7 per cent), and Germany (share 3.2 per cent) in that order.

GROWTH AND STRUCTURE OF INDIA'S FOREIGN TRADE SINCE 1991

Commencing July 1991, the Government of India has initiated a number of measures to 'open up' the foreign trade sector and has announced massive import liberalisation measures over the last decade and a half. These include devaluation of the rupee in July 1991 and subsequently its depreciation against the currencies of leading industrialized countries, introduction of the convertibility of rupee first on trade account and then for all current account transactions, liberalization of import regime, substantial reduction in customs tariff rates, decanalising of many items of trade, wide ranging measures to give a thrust to exports, etc. In fact, the trade policy reforms initiated in 1991 have drastically changed the scenario and have resulted in a shift from the inward-oriented policy of the past to an outward-oriented policy. In this last section of the Chapter, we propose to discuss the growth and structure of India's foreign since 1991.

Expansion of Foreign Trade

India's trade has increased significantly in the post-reform period. In absolute terms, the trade volume rose from US $ 42.2 billion ($18.1 billion exports and $ 24.1 billion imports) in 1990-91 to US $ 316.90 billion ($ 126.33 billion exports and $ 190.57 billion imports) in 2006-07. However, since 1992-93 the rate of increase of imports has been consistently higher than the rate of increase of exports (in dollar terms) excepting 1993-94, 2000-01 and 2002-03. As a result, trade deficit increased substantially from $ 1.5 billion in 1991-92 and $ 3.3 billion in 1992-93 to as high as $ 12.8 billion in 1999-2000 and further to $ 64.23 billion in 2006-07.

Important observations regarding India's trade performance during the post-reform period are as follows :

1. Reflecting the liberalisation of trade regime and the increasing external openness of the economy, India's trade-GDP ratio showed substantial improvements during the 1990s as compared with the earlier decades. The export-GDP ratio rose from 4.5 per cent in 1970s (1970-71 to 1979-80) and 4.6 per cent in 1980s (1980-81 to 1989-90) to 7.8 per cent in 1990s (1990-91 to 1999-2000). It rose further to 13.9 per cent in 2006-07. The import-GDP ratio also rose from 5.3 per cent in 1970s to 7.2 per cent in 1980s and further to 9.3 per cent in 1990s. In 2006-07, the import-GDP ratio was 21.1 per cent. The overall trade-GDP ratio increased from 9.8 per cent in 1970s to 11.8 per cent in 1980s and further to 17.1 per cent in 1990s. ***These data indicate an increasing openness of the Indian economy in 1990s and given India's own economic past "represents a significant change in its relationship with the world economy."***[3]

2. The export-import ratio (which indicates the proportion of imports that can be financed from export earnings) increased substantially from 64.0 per cent during 1980s to 84.9 per cent during 1990s and stood at 81.7 per cent in 2003-04. However, it deteriorated thereafter and fell to 75 per cent in 2004-05 and 66 per cent in 2006-07.

3. Both export growth and import growth rates registered an increase in the post reform period *vis-a-vis* 1980s. For instance, the average annual export growth rate rose from 8.1 per cent in 1980s to 8.6 per cent in 1990s while the average annual import growth rate rose from 7.2 per cent to 9.6 per cent over the same period.

4. However, a little calculation on the rates of growth in 1990s shows that the performance in the second half of 1990s deteriorated considerably as compared with the first half of 1990s. For instance, on an average annual basis, export growth during the first half of 1990s (1992-93 to 1995-96)[4] was 15.7 per cent which fell considerably to only 3.9 per cent in the second half of 1990s (1996-97 to 1999-2000). Similarly, on an average annual basis, import growth fell from 17.5 per cent in the first half of 1990s to 8.0 per cent during the second half of 1990s.

5. The year 2001-02 was bad as exports declined by 1.6 per cent. Imports, on the other hand, rose marginally. However, both exports and imports rose significantly in the later years. ***As far as expansion in foreign trade is concerned, the most significant year in the entire period of planning has been the year 2004-05. In this year exports increased by 30.8 per cent over the previous year while imports increased by 42.7 per cent over the previous year.***

Changes in Composition of Exports

Important changes have taken place in the composition of exports during the post-reform period as would be clear from the discussion below:

1. The share of agriculture and allied products in total exports was 19.4 per cent (*i.e.* one-fifth) in 1990-91. This fell to 10.2 per cent (*i.e.* one-tenth) in 2005-06.

2. Manufactured products account for a major share of the increase in aggregate exports over the period 1990-91 to 2005-06. It can be calculated from Table 41.3 that of the total increase in export earnings of $ 84,948 million over the period, exports of manufactured goods accounted for as much as $ 60,970 million, *i.e.* 71.8 per cent.

3. Gems and jewellery was the most important export item in 1990-91 with its share in total export earnings being 16.1 per cent. It has consistently maintained its share at about 15-17 per cent all through the post-reform period but in terms of importance (as far as share in export earnings is concerned) it now occupies the second place after engineering goods.

4. The second most important export item in 1990-91 was readymade garments with their share in export earnings being 12.8 per cent. However, it was soon pushed down to third place by engineering goods. In 2005-06, the share of readymade garments in export earnings was 8.3 per cent and they occupied the fourth place after engineering goods, gems and jewellery and chemicals and allied products.

5. Engineering goods occupied the third place in India's export earnings in 1990-91 with a share of 11.9 per cent. In 2005-06 they occupied the first place with a share of 20.7 per cent. Thus, ***engineering goods now contribute one-fifth of total export earnings***. Their share in incremental export earnings over the period 1990-91 to 2005-06 is as high as 22.6 per cent ($19,157 million out of $ 84,948 million).

6. Exports of chemicals and allied products which were $ 1,176 million in 1990-91 rose to $ 11,935 million in 2005-06. As a result, the percentage share of chemicals and allied products almost doubled over the period from 6.5 per cent in 1990-91 to 11.6 per cent in 2005-06. An important reason for this improved performance has been an increase in the exports of drugs, pharmaceuticals and fine chemicals.

7. The share of leather and leather manufactures in export earnings declined steeply from 8 per cent in 1990-91 to 3.4 per cent in 2003-04 and further to 2.6 per cent in 2005-06.

8. Because of the rising demand for iron ore by Chinese iron and steel industry, the exports of iron ore from India have suddenly shot up. While iron one worth $1,126 million was exported in 2003-04, in a year's time (*i.e.* in 2004-05) the exports of iron ore jumped to $ 3,277 million. They rose further to $ 3,801 million in 2005-06.

9. The changes in the structure of India's exports during the post-reform period are more noticeable at the disaggregated level. In certain years during this period, exports of rice, tobacco, spices, sugar and molasses, and works of art (excluding floor coverings) increased significantly.

10. India's manufacturing exports are showing tendencies of shifting away from traditional exports towards relatively manufactured products. An encouraging trend from the point of view of future growth is that in recent years, ***exports of electronic goods and computer goods have shown good performance.***

11. In addition to changes in the composition of merchandise exports, it is also necessary to emphasize the sharp rise in service exports since 1991 and changes in the composition of service exports. ***Between 1992 and 2005-06, India's exports of services increased from $ 4.9 billion to $ 61.4 billion.*** As far as composition of service exports is concerned, the relative share of travel and transportation in India's exports which was as high as 64 per cent in 1995-96 fell to 30 per cent in 2003-04 while that of software exports rose from 10 per cent to 49 per cent over the period. ***In 2005-06, software and ITES exports from India were $ 23.4 billion (which was 32 per cent higher than these exports in 2004-05). This was 38 per cent of total $ 61.4 billion of export of services in this year.***[5]

12. Another promising area that is emerging is project exports. There is a growing realisation across Asia and Africa that the experience of Indian companies is more appropriate to their project needs, especially in hydro-power, irrigation, transportation and water supply systems. As a result, exports of projects and services including construction and industrial turnkey projects and consultancy services increased from $ 629 million in 1998-99 to $ 911 million in 2004-05.

Changes in Composition of Imports

Important observations regarding the composition of India's imports and structural changes therein during the post-reform period are as follows:

1. ***The most important import item in terms of expenditure is POL (petroleum, oil and lubricants).*** The share of POL in total import expenditure was 25.0 per cent in 1990-91 and 29.5 per cent in 2005- 06. In fact,

for most of the post-reform period POL imports have accounted for one-fourth (or more than one-fourth) of total import expenditure.

A point that needs to be noted here is the compositional shifts within the broad level of aggregation during the last decade. For instance, within the petroleum imports, there has been a shift from import of petroleum products towards crude imports following a large scale increase of refinery capacity over time. Furthermore, India has transformed itself from a net importer of finished petroleum products to net exporter of the same in 2001-02.[6]

2. To meet the requirements of the gems and jewellery industry (which is an important export industry of the country) pearls and precious and semi-precious stones are imported in large quantities. These imports amounted to $ 2,083 million in 1990-91 and $ 9,134 million in 2005-06. In percentage terms, however, the share of pearls and precious and semi-precious stones has remained almost constant at 8-9 per cent of total import expenditure all through the post-reform period (however, in 2005-06, it fell to 6.1 per cent).

3. As is clear from Table 41.2, imports of capital goods at $ 5,833 million in 1990-91 accounted for 24.2 per cent (*i.e.* almost one-fourth) import expenditure in 1990-91. The figures for 2004-05 and 2005-06 show a steep decline in the share of capital goods imports in total import expenditure (13.0 per cent in 2004-05 and 15.8 per cent in 2005-06). However, this is due to the reason that from 1991-92 onward data on non-electrical machinery and electric machinery exclude electronic goods and computer goods. If imports of these are also taken into account, the imports of capital goods account for 22.5 per cent import expenditure in 2004-05 and 22.4 per cent import expenditure in 2005-06.[7] Thus, it can be safely said that ***capital goods imports accounted for one-fifth to one-fourth of import expenditure during the post-reform period.***

4. As a result of liberalisation of trade policy in the post-reform period and changing consumer tastes, imports of electronic goods and computer goods have increased substantially during the recent years. During 1993-94, imports of electronic goods and computer goods were worth $ 930.4 million which was just 4 per cent of total import expenditure. In 2000-01, their imports had risen to $ 3,694.5 million which was 7.3 per cent of total import expenditure. In 2005-06, import of electronic goods and computer goods rose further to $ 14,087 million which was 9.9 per cent of total import expenditure (in other words, ***electronic goods and computer goods now account for roughly one-tenth of total import expenditure).***

5. There has been a steep fall in the imports of project goods during recent period. The share of import of project goods in total import expenditure was 6.3 per cent in 1998-99 which fell drastically to only 0.6 per cent in 2005-06.

6. The share of fertilisers in import expenditure fell from 4.1 per cent in 1990-91 to only 1.3 per cent in 2005-06. Over the same period the share of iron and steel in import expenditure fell from 4.9 per cent to 3.1 per cent.

7. The share of chemical elements and compounds in total import expenditure remained stable at 5-6 per cent all through the post-reform period.

8. Data on imports of gold and silver since 1999-2000 are now available (the reason is that these imports are now channelised through the official routes). These data show that gold and silver imports were of $ 4,706 million in 1999-2000 and these rose to $11,189.4 million in 2005-06. ***Percentage share of gold and silver in total import expenditure was 8 per cent in 2005-06.***

9. The last few years have seen considerable increase in imports of coal, coke and briquettes etc. (in absolute terms). From $ 440 million in 1990-91 these imports rose to $1,103 million in 2000-01 and further to $ 2,802 million in 2004-05. According to Tendulkar, this is due to steep reduction in import duties, which introduced external competition for the State monopoly Coal India Ltd. Moreover "users (especially in coastal States) found that compared with coke sold by Coal India, imported coke was cheaper and of a better quality."[8]

Direction of Imports in the Post-Reform Period

As is clear from Table 41.4, the share of OECD group of countries declined from 54.0 per cent in India's imports in 1990-91 to 36.5 per cent in 2006-07. The main reason for this was a fall in the share of EU from 29.4 per cent in 1990-91 to 17.6 per cent in 2006-07. The share of Eastern Europe which was 7.8 per cent in 1990-91 fell drastically to only 2.4 per cent in 2006-07 because of the setback to socialist bloc and particularly the disintegration of USSR. The share of OPEC countries which was 16.3 per cent in 1990-91 rose to 22.5 per cent in 1999-2000 but within a year fell drastically to only 5.1 per cent in 2000-01. However, it rose to as high as 29.4 per cent in 2006-07. The share of developing countries in India's imports was 18.6 per cent in

1990-91 and this rose considerably to 31.3 per cent in 2006-07. Of these, imports from Asian countries are the most important.

As far as the share of different countries in India's imports is concerned, USA occupied the first position in 1990-91 with a share of 12.1 per cent followed by Germany (share 8.0 per cent), Japan (share 7.5 per cent), UK and Saudi Arabia (share 6.7 per cent each) and Belgium (share 6.3 per cent) in that order. In 2006-07, China occupied the first position with a share of 9.1 per cent followed by Saudi Arabia (share 7.0 per cent), Germany (share 6.6 per cent), USA (share 6.6 per cent), UAE (share 5.0 per cent), Singapore (share 2.9 per cent) and Malaysia (share 2.8 per cent) in that order.

Direction of Exports in the Post-Reform Period

The OECD group of countries accounted for more than half of India's export earnings during 1990s. Their share in India's exports was 53.5 per cent in 1990-91 which fell to 41.2 per cent in 2006-07. In 1990-91 almost half of the exports to OECD countries were accounted for by EU countries. Taken separately, EU accounted for 21.8 per cent of India's export earnings in 1990-91 and 20.4 per cent in 2006-07. The share of OPEC group in India's export earnings was 5.6 per cent in 1990-91 which rose to 16.3 per cent in 2006-07. Because of the disintegration of communist regimes, the share of Eastern Europe in India's export earnings fell drastically from 17.9 per cent in 1990-91 to 10.9 per cent in 1991-92 and to merely 2.0 per cent in 2006-07. What is significant from India's point of view is the fact that the share of developing nations of Africa, Asia and Latin America has risen considerably over the seventeen year period 1990-91 to 2006-07 from 17.1 per cent to 40.1 per cent. Most important in this group have been the countries of Asia. In fact, these countries accounted for 29.7 per cent of India's export earnings in 2006-07.

As far as the share of different countries in India's export earnings is concerned, USSR with a share of 16.1 per cent occupied the first position in 1990-91. USA occupied the second position with a share of 14.7 per cent followed by Japan (share 9.3 per cent). The position changed markedly thereafter due to the disintegration of the USSR. As is clear from Table 41.4, Russia accounted for only 0.7 per cent of India's export earnings in 2006-07. In this year, USA with a share of 14.9 per cent occupied the first place. It was followed by UAE (share 9.5 per cent), China (share 6.6 percent), Singapore (share 4.8 per cent), UK (share 4.4 per cent), Hong Kong (share 3.7 per cent) and Germany (share 3.2 per cent) in that order.

Table 41.4 and the discussion above show that significant changes have taken place in the direction of India's foreign trade since 1991 and more particularly during the last three-four years. What is significant is the emergence of China, Singapore, Hong Kong, South Korea and Malaysia as important trading partners from the Asian region, Switzerland from OECD countries, and UAE and Indonesia from OPEC.

According to *Handbook of Statistics on Indian Economy*, 2006-07 ***the top eleven trading partners of India (exports and imports combined) during 2006-07 were as follows :USA (share 9.9 per cent), China (share 8.1 per cent), UAE (share 6.8 per cent), Germany (share 5.2 per cent), South Africa (share 5.0 per cent), Singapore (share 3.6 per cent), U.K. (share 3.1 per cent), Switzerland (share 3.0 per cent), Hong Kong and South Korea (share 2.3 per cent each), and Malaysia (share 2.1 per cent).***[9]

NOTES

1. Government of India, *Economic Survey, 2006-07* (Delhi, 2007), pp. 113-14.
2. In absolute terms, imports from Germany were of $ 12,666.5 million and from U.S.A. $ 12,604.7 million in 2006-07 (the total imports being $ 1,90,556 million).
3. Baldev Raj Nayar, "Opening Up and Openness of Indian Economy" *Economic and Political Weekly,* September 15, 2001, p. 3532.
4. The year 1991-92 in left out as it was as exceptional year.
5. Government of India, *Economic Survey,* 2006-07 (Delhi, 2007), p.121.
6. Reserve Bank of India, *Report on Currency and Finance, 2002-03* (Mumbai, 2004), p. 100.
7. Calculated from Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2005-06* (Mumbai, 2006), Table 138, p. 216.
8. Suresh D. Tendulkar, "India in the World Trading System : A Quantitative Assessment" in T.N. Srinivasan and Suresh D. Tendulkar, *Reintegrating India with the World Economy* (New Delhi, 2003), p. 48.
9. Reserve Bank of India, *Handbook of Statistics on Indian Economy 2006-07* (Mumbai, 2007), Table 139, pp. 227-9.

CHAPTER

42 INDIA'S BALANCE OF PAYMENTS

India's Balance of Payments: The Pre-1991 Period
• Current Account Deficit in Balance of Payments • Capital Account : Financing the Deficit
Balance of Payments Situation Since 1991
Reasons for Satisfactory Balance of Payments Situation in Post-Reform Period
The Management of Balance of Payments
• Linkages between Fiscal and External Polices • Issues Relating to Trade Strategy (The Trade Policy Debate) • Exchange Rate Management • Issues Pertaining to the Capital Account • External Debt • Foreign Currency Reserves and Reserve Management Strategy

The balance of payments of a country is a systematic record of all economic transactions between the 'residents' of a country and the rest of the world carried out in a specific period of time. It presents a classified record of all receipts on account of goods exported, services rendered and capital received by residents, and payments made by them on account of goods imported and services received from, and capital transferred to 'non-residents' or foreigners. Thus, ***balance of payments is a much wider term as compared to balance of trade.*** Whereas the latter refers only to merchandise imports and exports, the former refers to all economic transactions with the outside world.

The balance of payments statement is divided into two major accounts; *viz,* current account and capital account. The current account is divided into 'Merchandise', 'Non-monetary gold movement', and 'Invisibles.' Invisibles are further classified into services (comprising travel, transportation, insurance, investment income, government not included elsewhere and miscellaneous) and transfer payments (unrequited transfers, *e.g.*, grants, gifts, taxes, etc.). The capital account includes those economic transactions which result in changes in the foreign financial assets and liabilities. Capital transactions are classified into three main sectors, *viz.*, 'Private', 'Banking' and 'Official.'

In this chapter, we propose to discuss

- India's balance of payments : The pre-1991 period.
- Balance of payments situation since 1991.
- Reasons for satisfactory balance of payments in the period since 1991.
- The management of balance of payments.

INDIA'S BALANCE OF PAYMENTS: THE PRE-1991 PERIOD

The balance of payments situation was satisfactory in the First Plan as the deficit in current account was merely Rs. 42.3 crore. However, the period since the Second Plan was marked by extreme difficulties on the balance of payments front excepting a few years, as foreign exchange payments consistently remained substantially higher than foreign exchange receipts. Bimal Jalan has classified the pre-1991 period into three sub-periods:

1956-57 to 1975-76 (period I), 1976-77 to 1979-80 (period II) and 1980-81 to 1990-91 (Period III).[1] While periods I and III were characterised by persistent balance of payments problem, period II saw a substantial improvement in the balance of payments and the foreign exchange reserve position. ***Jalan used the following two criteria as a rough measure of the balance of payments problem in a particular year: (i) the current account deficit was more than one per cent of GDP and (ii) the foreign exchange reserves were less than necessary to cover three months' imports.*** During period II, there was in fact a surplus on current account (which stood at 0.6 per cent of GDP) and reserves were sufficient to cover more than three month's imports. As against this, in periods I and III, there was a current account deficit of 1.8 per cent of GDP. However, in both these periods, there were some years during which reserves exceeded three months' imports. But, on the whole, the overall balance of payments situation continued to be difficult.

Current Account Deficit in Balance of Payments

Period I : 1956-57 to 1975-76. This period comprising the Second, Third and Fourth Plans and the first two years of the Fifth plan saw ***heavy deficits in balance of payments and an extremely tight payments position.*** Let us consider the situation plan-wise. The Second Plan gave primary importance to the establishment and development of basic and capital goods industries. This necessitated large-scale imports of capital equipment, machinery and technical know-how. Throughout the Second Plan period, exports were stagnant and the value of imports was almost double the value of exports. As a result, the deficit in balance of trade was Rs. 2,261.3 crore. The only redeeming feature was that receipts on invisibles remained positive as in the First Plan and, as a result, the overall deficit on current account was reduced to Rs. 1,646 crore. The overall deficit in balance of payments during the Third Plan rose to Rs. 1,972 crore. As far as Fourth Plan is concerned, it registered continuous increase in imports mainly due to increase in international prices. For example, the Organisation of Petroleum Exporting Countries (OPEC) raised the price of crude oil from $ 2.50 to $ 3.00 per barrel in the middle of 1973 to $11.65 per barrel in early 1974, *i.e.* by about four times. The prices of fertilisers, iron and steel, non-ferrous metals and various types of capital equipment also increased substantially in 1972-73 and 1973-74 (the last two years of the Fourth Plan). As a result, the deficit on current account during the Fourth Plan was as high Rs. 2,221 crore. The first two years of the Fifth Plan (1974-75 and 1975-76) recorded a deficit of Rs. 1,738 crore in the current account.

Period II : 1976-77 to 1979-80. This brief four year period was a ***golden period*** as far as the balance of payments is concerned. As stated earlier, ***India had a small current account surplus of 0.6 per cent of GDP during this period and it also possessed foreign exchange reserves equivalent to about seven months' imports.*** The relatively comfortable position on the balance of payments front was due to the following factors: (1) First and foremost was the rapid increase in private remittances from oil exporting countries. A large number of Indian workers temporarily migrated to the oil-rich middle east countries to work there as unskilled workers, skilled technicians, office assistants, nurses etc. They kept sending their net earnings to their families in India. As a result, transfer payments to India on private account aggregated Rs. 3,128.7 crore over the Fifth Plan period; (2) There was a strong growth in exports of nearly 31 per cent in 1975-76 over 1974-75 and of 23 per cent in 1976-77 over 1975-76 (in rupee terms); (3) As a result of the conservation measures adopted domestically and increase in oil production, the country was able to arrest the growth in oil imports; (4) There was a substantial expansion in the activities of Indian firms in the oil exporting middle east countries. Indian firms were building roads, airports, housing estates, power stations, steel mills, etc., in a number of middle-east countries. These exports of construction services as well as of some materials contributed substantially to India's foreign exchange earnings; and (5) Aid receipts were reasonably buoyant and India drew on various International Monetary Fund facilities during the years 1973-74 to 1975-76.

Period III : 1980-81 to 1990-91. This period covering roughly the Sixth Plan (1980-81 to 1984- 85) and Seventh Plan (1985-86 to 1989-90) was marked by ***severe balance of payments difficulties.*** In fact, during the first four years of the Sixth Plan (1980-81 to 1983-84), the deficit in balance of trade was around Rs. 6,000 crore per annum. In the last year of the Plan, this shot upto Rs. 6,721 crore. The trade deficit in the first three years of the Seventh Plan (1985-86 to 1987-88) exceeded Rs. 9,000 crore per annum and in the fourth and fifth years (1988-89 and 1989-90) exceeded Rs. 12,000 crore per year. ***In 1990-91 the deficit touched the astronomical figure of Rs. 16,934 crore.*** This shows the difficult position that the country faced on the balance of payments front.

Earnings from invisibles were substantial throughout the Sixth Plan period. They touched the highest level ever in the planning period during 1980-81. In that year they stood at Rs. 4,311 crore. In subsequent years

of the plan, earnings from invisibles declined somewhat but in each year they were Rs. 3,500 crore or more. However, during the Seventh Plan period private remittances from middle-east countries showed tendencies of flattening out. As a result, earnings from invisibles declined consistently and fell to Rs.1,025 crore in 1989-90. Whereas net invisibles financed, on an average, more than 60 per cent of trade deficit during the Sixth Plan, they financed only 24 per cent of trade deficit during the Seventh Plan.

The Gulf Crisis during the year 1990-91 further worsened the balance of payments problem. In addition to a massive trade deficit of Rs. 16,934 crore, there was deterioration in the invisibles account as well because of lower remittances and higher interest payments. ***The current account deficit soared to Rs.17,369 crore.***

Capital Account: Financing the Deficit

A study of capital account of the balance of payments reveals the methods of financing the deficit in the current account of the balance of payments. ***During period I (1956-57 to 1975-76) and period II (1976-77 to 1979-80), almost the entire deficit was financed through inflows of concessional assistance and this kept the debt servicing burden low. In contrast, a substantial part of the deficit (indeed almost the entire incremental deficit, in dollar terms) had to be financed through non-concessional loans obtained on market related terms during period III.*** As noted by Jalan, disbursements on concessional terms constituted more than 89 per cent of assistance to India from multilateral sources in 1980. This proportion declined to about 35 per cent in 1990. The average maturity of loans from official sources also declined from 40.8 years in 1980 to 29.1 years in 1990. At the same time, the average rate of interest increased. Thus there was deterioration in the 'quality' of external financing. As a result, the total debt increased from Rs. 19,470 crore in 1980-81 to as high as Rs.1,63,001 crore at end-March 1991. After 1984-85, the large current account deficit had to be financed through substantial inflows of capital by way of commercial borrowings and deposits by Non-resident Indians (NRIs). This increased the cost of external debt considerably over time. As a result, the debt-service ratio rose to 35.3 per cent in 1990-91 and stood at 30.2 per cent in 1991-92. The debt to GDP ratio also rose significantly to 41.0 per cent in 1991-92. The country also had to seek substantial assistance from IMF (International Monetary Fund).

The above discussion shows that the balance of payments situation turned grim in period III. With increasing trade deficits, flattering out of ***private remittances and a fall in concessional aid to finance the ever increasing deficits, India had to depend on high cost methods of financing the deficit, viz., external commercial borrowings, NRI deposits and assistance from IMF.*** IMF loans are generally packaged with high conditionalities. As far as external commercial borrowings and NRI deposits are concerned, they represent a 'substantial future liability.' Moreover, large outflows in any year could seriously deplete reserves. This happened in 1990-91 and 1991-92 as the international confidence in India's abilities was shaken leading to a downgrading of India's credit rating. Bimal Jalan has estimated that, on an annual basis, in 1990-91, there was a net erosion of Rs. 4,094 crore in receipts from commercial banks and NRI deposits as compared with total receipts from these sources in 1989-90. On a proportionate basis, for the 18 month period, July 1990 to December 1991, the erosion in receipts from these sources could be of the order of Rs.6,000 crore.[2]

BALANCE OF PAYMENTS SITUATION SINCE 1991

The balance of payments situation since 1991 has been distinctly different from the situation that prevailed in the earlier period excepting the years 1991-92 and 1992-93. Since 1991-92 was an exceptional year, it is left out of discussion. Consequently Table 42.1 on balance of payments situation since 1991 starts from the year 1992-93.

The situation in 1992-93 was in line with earlier years as the current account deficit was 1.7 per cent of GDP (during 1980-81 to 1990-91, it was 1.8 per cent of GDP), imports grew by 15.4 per cent on balance of payments basis while the growth of exports was just 3.3 per cent on balance of payments basis. The import cover of foreign exchange reserves was also of only 4.9 months. However, balance of payments situation improved considerably in 1993-94. In this year, the current account deficit was only 0.4 per cent of GDP, foreign exchange reserves were sufficient to cover eight and a half months' imports and external assistance was substantially higher than the current account deficit (in this year, external assistance (net) stood at $ 1,901 million as against the current account deficit of $ 1,158 million). Another important development in 1993-94 was the exceptionally good performance on the export front. Exports recorded a growth of 20.2 per cent on balance of payments basis, in dollar terms, against an increase of 10.0 per cent in imports. As a result, current account deficit fell from $ 3.5 billion in 1992-93 to $1.2 billion in 1993-94. All these facts show that ***there was a marked 'turnaround' in the balance of payments situation in 1993-94.***

TABLE 42.1. India's Balance of Payments Situation Since 1991 : Some Indicators

Indicator	1992-93	1993-94	1995-96	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07 (P)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
1. Current account balance (as % of GDP)	–1.7	–0.4	1.7	–0.6	0.7	1.2	2.3	–0.4	–1.1	–1.1
2. Import cover of foreign exchange reserves (no. of months)	4.9	8.6	6.0	8.9	11.7	14.2	16.9	14.3	11.6	12.4
3. Imports, dollar values (annual growth rate)	15.4	10.0	21.6	4.6	–2.8	14.5	24.1	48.6	32.0	22.3
4. Exports, dollar values (annual growth rate)	3.3	20.2	20.3	21.1	–1.6	20.3	23.3	28.5	23.4	20.9

P. Provisional

Source : Reserve Bank of India, *Annual Report, 2006-07* (Mumbai, September 2007), Table 1.77, p. 89 and Appendix Table 48, p. 330.

The situation in 1994-95 was also satisfactory on many counts. Current account deficit was only 1.0 per cent of GDP and foreign exchange reserves were sufficient to finance 8.4 months' imports. However, there was a sharp rise in imports due to pick up in industrial activity while the rate of growth of exports decelerated a bit (data for 1994-95 not given in the Table).

The growth in imports continued unabated in 1995-96 as well due to renewal of economic growth. Imports in dollar value grew by 21.6 per cent in this year. However, exports with a growth of 20.3 per cent almost matched the rate of increase in imports (see Table 42.1). Foreign exchange reserves in 1995-96 were enough to finance six months' imports. However, the current account deficit which stood at $ 3.4 billion in 1994-95 rose to $ 5.9 billion in 1995-96. This was 1.7 per cent of GDP. In fact, 1995-96 was the only year in the post-reform period to register a foreign exchange reserve draw down of $ 2.9 billion (see Table 42.2).

The year 1996-97 witnessed a reduction in current account deficit from $ 5.9 billion in 1995-96 to $ 4.6 billion. This was 1.2 per cent of GDP. The balance of payments situation improved considerably and there was a reserve build up of $ 5.8 billion. However, in 1997-98, the deficit on current account of the balance of payments widened to $ 5.5 billion or 1.4 per cent of GDP. But the balance of payments situation remained comfortable with reserve accumulation of $ 3.9 billion supported by strong private capital flows. The deficit in the current account of balance of payments declined to 1.0 per cent of GDP in 1998-99 mainly reflecting sharp declines in POL and non-customs imports. In fact, although exports declined by 3.9 per cent in 1998-99, the decline in imports was much more at 7.1 per cent. There was a reserve accumulation of $ 3.8 billion and the situation on the balance of payments front was comfortable.

After registering negative rates of growth in 1998-99, exports and imports both bounced back considerably in 1999-2000. Total imports, on balance of payment basis, expanded sharply by 16.5 per cent largely because of a 63.8 per cent increase in the oil import bill. Exports, on the other hand, rose by 9.5 per cent. As a result, the trade deficit rose to $ 17.8 billion but a surge in net inflow of invisibles to as much as $ 13.14 billion helped in bringing down the current account deficit to $ 4.7 billion. This moderation in current account deficit was accompanied by a sharp increase in net capital inflows with the result that foreign exchange reserves rose by a substantial $ 6.14 billion. The foreign exchange reserves both in 1998-99 and 1999-2000 were sufficient to finance 8.2 months' imports.

The balance of payments situation improved further in 2000-01 and the current account deficit in this year narrowed further to about 0.5 per cent of GDP from 1.0 per cent of GDP in the previous year. The reserve accumulation in this year stood at $ 5.84 billion (see last column of Table 42.2). From the point of view of balance of payments, most significant have been the three years 2001-02, 2002-03 and 2003-04. ***In all these years, there was a surplus on current account.*** The surplus on current account was 0.7 per cent of GDP in 2001-02, 1.2 per cent of GDP in 2002-03 and 2.3 per cent of GDP in 2003-04. ***It is the first time in post-Independence period that there was a current account surplus for three consecutive years.*** This surplus was also accompanied by strong net capital inflows. For example, the current account surplus in 2001-02 was $ 3,400 million and net capital inflows were of $ 8,357 million. As a result, there was a reserve build-up of $ 11.76 billion in this year. This increased to $16.99 billion in 2002-03. Most significant was the year 2003-04.

TABLE 42.2. India's Balance of Payments : 1993-94 to 2006-07

Year	*Trade Balance*	*Invisibles*	*Current Account (Net)*	*Capital Account Total (Net)*	*Reserve use (–increase)*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
1993-94	–4056	2898	–1158	9882	-8724
1994-95	-9049	5680	-3369	8013	–4644
1995-96	-11359	5449	-5910	2974	2936
1996-97	-14815	10196	–4619	10437	-5818
1997-98	-15507	10007	-5500	9393	-3893
1998-99	-13246	9208	–4038	7867	-3829
1999-2000	-17841	13143	–4698	10840	-6142
2000-01	-12460	9794	-2666	8508	-5842
2001-02	-11574	14974	2400	8357	-11757
2002-03	-10690	17035	6345	10640	-16985
2003-04	-13718	27801	14083	17338	-31421
2004-05	-33702	31232	-2470	28629	-26159
2005-06	-51841	42655	-9186	24238	-15052
2006-07 (P)	-64905	55296	-9609	46215	-36606

P: Provisional

Source : (*i*) Government of India, *Economic Survey, 2006-07.* Table 6.2, p. 108; and (*ii*) Reserve Bank of India, *Handbook of Statitics on Indian Economy 2006-07* (Mumbai, 2007),Table 144, pp. 243-5.

Because of strong earnings of $ 27,801 million from invisibles in this year, the current account surplus rose to $ 14,083 million. Since net capital inflows in this year were as high as $ 17,338 million, the reserve build-up in this year amounted to as much as $ 31.42 billion. The import cover of foreign exchange reserves rose to 16.9 months in this year.

After recording a surplus for three years in row, the current account once again recorded a deficit in 2004-05. As is clear from Table 42.2, the current account deficit in this year was $ 2,470 million (which was 0.4 per cent of GDP). This deficit was caused by a burgeoning excess of merchandise imports over exports, which was left uncompensated by the net surplus in invisibles. However, because of strong increase in net capital inflows (which rose from $ 17.34 billion in 2003-04 to $ 28.63 billion in 2004-05) there was a reserve accumulation of $ 26.16 billion in 2004-05. The year 2005-06 registered a high trade deficit of $ 51,841 million primarily because of rising oil prices.[3] As a result, despite impressive positive earnings of as much as $ 42,655 million from invisibles, the current account deficit in this year was as high as $ 9,186 million which was 1.1 per cent of GDP. Because of $ 24,238 million surplus on capital account, the foreign exchange reserves increased by $ 15.05 billion. ***The year 2006-07 registered the highest trade deficit of $ 64,905 million recorded so far. However, because of positive earnings of $ 55,296 million from invisibles the current account deficit was $ 9,609 million. This year also recorded the highest capital inflows of as much as $ 46,215 million recorded so far with the result that there was a robust reserve accumulation of $ 36.61 billion (highest in any single year).***

REASONS FOR SATISFACTORY BALANCE OF PAYMENTS SITUATION IN POST-REFORM PERIOD

As is clear from the discussion above, the balance of payments situation since 1991 has been quite satisfactory. Excepting the year 1995-96, there has been substantial reserve accumulation in all other years. The reasons for this satisfactory position are as follows:

High Earnings from Invisibles. Table 42.2 brings out clearly the role played by invisibles in the balance of payments since 1991. As is clear from the Table, invisibles have all along contributed positive earnings since 1991 while there were always heavy deficits on trade account. The positive earnings from invisibles covered a substantial part of the trade deficit with the result that the current account deficit was reduced significantly. In 1993-94, the trade deficit was $ 4.06 billion while net earnings from invisibles were $ 2.90 billion. Thus, invisibles covered 71.4 per cent of the trade deficit. A little calculation on the data presented in Table 42.2 brings out that invisibles covered 62.8 per cent trade deficit in 1994-95,73.7 per cent in 1999-2000 and 82.0 per cent in 2000-01. ***Earnings from invisibles exceeded the deficit on trade account in 2001-02, 2002-03 and 2003-04 with the result that there was a surplus on current account in these years.*** In 2004-05, 2005-06 and 2006-07, invisibles covered 92.7 per cent, 82.3 per cent and 85.2 per cent of trade deficit respectively.

The impressive role played by invisibles in covering trade deficit is due to a sharp rise in invisible receipts *vis-a- vis* payments since 1992-93. The main contributing factors to rise in invisible receipts are non-factor services 'receipts and private transfers. As far as non-factor services' receipts are concerned, the main development has been the rapid increase in the exports of software services. In fact, ***in a period of just two years, 2003-04 to 2005-06, software service exports almost doubled from $12.9 billion to $ 23.4 billion.*** As far as private transfers are concerned, their main constituent is workers' remittances from abroad. Over the last five years, remittances have doubled from $ 11 billion to $ 23.4 billion in calendar year 2006. Remittances now account for 3 per cent of India's GDP and are more than foreign direct investment and foreign institutional investment put together (FDI flows into India were $ 4.7 billion and FII inflows $ 12.5 billion in 2005-06). ***India is now the highest remittance receiving country of the world accounting for almost 10 per cent of total global remittances.***[4]

It is on account of the above reason that Shankar Acharya has recently argued that ***it is the surges in software exports and private remittances that are the main new contributors to improvement in the balance of payments situation in recent years.***[5]

Rise in External Commercial Borrowings. External commercial borrowings were used extensively in the latter half of 1980s to finance the current account deficit. In fact, in this period, external commercial borrowings accounted for more than 25 per cent of the total capital inflows into the economy. During some years in 1990s also, the dependence on external commercial borrowings has been quite high. For instance, of the total capital inflows (net) of $ 4,563 million in 1991-92, the share of external commercial borrowings was $ 1,456 million, *i.e.* 31.9 per cent. Their share in 1995-96 was 42.9 per cent which rose further to 55.4 per cent in 1998-99 ($ 4,367 out of $ 7,867 million). However, during the years 2001-02 to 2003-04, external commercial borrowings were negative. ***During 2006-07, external commercial borrowings were $ 16,084 million which was 34.8 per cent (or more than one-third) of total capital inflows (net).***

Non-Resident Deposits. In addition to external commercial borrowings, the period of 1980s saw considerable increase in non-resident deposits also. This phenomenon continued right through the 1990s as well. In fact, the government has been offering various incentives to the non-resident Indians to bolster foreign exchange reserves of the country. As is clear from Table 42.3, non-resident deposits were $ 1,205 million in 1993-94 (which was 12.2 per cent of total capital inflows (net) in that year). The non-resident deposits rose to $ 2,978 million in 2002-03 and further to $ 3,642 million in 2003-04. However, ***there were net outflows from non-resident deposits in the year 2004-05 for the first time since 1990-91.*** In 2006-07, non-resident deposits were $ 3,895 million which was 8.4 per cent of total capital inflows (net) in that year.

Role of Foreign Investment. Since 1991 the government has been offering various concessions, facilities and incentives to the foreign investors with a view to encouraging foreign investment into the country.[6] These

TABLE 42.3. Inflows on Capital Account (Net) Since 1991

(US $ million)

	1993-94	*1995-96*	*1996-97*	*2001-02*	*2002-03*	*2003-04*	*2004-05*	*2005-06*	*2006 07 (P)*
1. External assistance (net)	1901	883	1109	1117	–3128	–2858	1923	1682	1770
2. Commercial borrowing (net)	607	1275	2848	–1585	–1692	–2925	5194	2723	16084
3. IMF (net)	187	–1715	–975	0	0	0	0	0	0
4. NR deposits (net)	1205	1103	3350	2754	2978	3642	–964	2789	3895
5. Rupee debt service	–1053	–952	–727	–519	–474	–376	–417	–572	–162
6. Foreign investment (net)	4235	4615	5963	6686	4161	13744	13000	17224	15499
of which									
(*i*) Foreign direct investment (net)	586	1954	2651	4734	3217	2388	3713	4730	8437
(*ii*) Foreign institutional investment (net) (net)	1665	2009	1926	1505	377	10918	8662	9926	3325
(*iii*) Euro-equities & others	1984	652	1386	447	567	438	625	2568	N.A.
7. Other flows (net)	2800	–2235	–1131	96	8795	6111	9983	392	N.A.
Capital Account (net)	**9882**	**2974**	**10437**	**8357**	**10640**	**17338**	**28629**	**24238**	**46,215**

P: Provisional

Source : (*i*) Government of India, *Economic Survey, 2006-07.* Table 6.2, p. 108; and (*ii*) Reserve Bank of India, *Annual Report 2006-07* (Mumbai, September 2007), Appendix Table 48, p. 330.

measures have helped in increasing foreign investment substantially in recent years. As is clear from Table 42.3, in many years since 1991 the share of foreign investment has been half or even more in total capital inflows (net) into the country. In 1993-94, foreign investment was $ 4,235 million which was 43 per cent of total capital inflows (net) of $ 9,882 million in the country. In 2002-03, foreign investment was $ 4,161 million and it rose significantly to $ 13,744 million in 2003-04, $ 13,000 million in 2004-05 and further to $ 17,224 million in 2005-06. In 2006-07, foreign investment was $ 15,499 million. In 2004-05, the share of foreign investment in total capital inflows (net) was 45.4 per cent which rose to as high as 71.0 per cent in 2005-06. However, it fell to 33.5 per cent in 2006-07.

Foreign investment is constituted of (1) foreign direct investment, and (2) portfolio investment. Portfolio investment, in turn, consists of *(i)* foreign institutional investment and *(ii)* Euro equities and others (which include Global Depository Receipts (GDRs), American Depository Receipts (ADRs) and offshore funds and others). In 2005-06, of the total foreign investment of $ 17,224 million, foreign direct investment (net) accounted for $ 4,730 million, foreign institutional investment (net) for $ 9,926 million and Euro equities and others for $ 2,568 million.

If we examine columns (4) and (5) of Table 42.2 we find that inflows on capital account total (net) were much larger than the deficits on current account over the period 1993-94 to 2000-01 (with the exception of 1995-96). As a result, there was considerable accumulation of reserves. During 2001-02 to 2004-05, since the current account was also in surplus, foreign exchange reserves accumulated at a still faster rate. In 2006-07, while there was a deficit of $ 9.6 billion in the current account, there was a surplus of as much as $ 46.22 billion in the capital account.

THE MANAGEMENT OF BALANCE OF PAYMENTS

In this section we propose to discuss some important issues relating to the management of balance of payments. The issues are (1) the linkages between fiscal and external policies, (2) issues relating to trade strategy, (3) exchange rate management, (4) issues pertaining to the capital account, (5) external debt, and (6) foreign currency reserves and reserve management strategy.

Linkages Between Fiscal and External Policies

As noted by C. Rangarajan, ***imbalances in the external sector reflect the fundamental fact that aggregate absorption in the economy is in excess of the domestically produced goods and services.***[7] Accordingly, measures to reduce excess demand in the economy constitute an important policy ingredient of the adjustment towards creating a sustainable balance of payments environment. While excess absorption can originate either from the private or the public sector (or both), Rangarajan argues that, in reality, it is the fiscal deficit of the public sector that is found to be associated with excess demand and the consequent deterioration of the current account balance. The link between the fiscal deficit and the current account balance can be derived from the following economy-wide financial balance identity:

Current Account Deficit = Income – (Consumption + Investment + Government Expenditure) = Fiscal Deficit + (Private Saving – Investment Gap)

In symbols, we can write

$$X - M = Y - (C + I + G) = (T - G) + (S_P - I_P)$$

While this is merely an *ex post* identity, it does bring out an important policy issue. It explicitly shows that an improvement in the current account balance can be achieved either by an improvement in the balances of the public sector (T – G) and the private sector ($S_P - I_P$) combined, or by an increase in national income (Y) relative to domestic absorption (C + I + G).

In a situation of crisis, the identity implies that serious policy measures aimed at curtailing domestic absorption will be a necessary pre-requisite for improving the external situation. As far as the medium term is concerned, the identity implies that a sustainable level of current account deficit is related to the relative rates of growth of income and absorption. Thus, "in any effort to maintain a reasonably comfortable level of current account deficit, domestic economic policy aimed at maintaining absorption at an appropriate level has an important role to play".[8] As far as the 'comfortable level of current account deficit' is concerned, Rangarajan feels that it should be no more than one per cent of the GDP.

Issues Relating to Trade Strategy (The Trade Policy Debate)

Trade strategies can be broadly divided into two groups, outward oriented and inward oriented. ***An outward oriented strategy is one in which trade and industrial policies do not discriminate between production for the domestic goods and foreign goods. A against this, inward oriented strategy is one in which trade and industrial incentives are biased in favour of production for the domestic market over the export market.*** While outward oriented strategy is often designated as the export promotion strategy, inward oriented strategy is designated as the import substitution strategy. The general instruments of an inward oriented strategy are commercial policy, industrial policy, and exchange rate policy. The inward oriented regimes are characterised by high levels of protection for manufacturing, direct controls on imports and investments, and overvalued exchange rates. As against this, outward orientation links the domestic economy to the world economy. The discriminatory use of tariffs, quotas, investment licensing, tax and credit subsidies, and so on, is incompatible with the purest form of outward oriented strategy.

Import Substitution Policy in India: Constraints to Growth. India opted for a strongly inward oriented strategy in the early decades of economic planning. The basic rationale for adopting this strategy was that it would help rapid industrialization through import substitution and at the same time save valuable foreign exchange. The policy succeeded in achieving both these objectives to a considerable degree. However, a number of economists and studies conducted all over the world have shown that outward oriented policies have performed better while inward oriented policies have constrained growth. For example, to examine the relationship between trade strategy and economic performance, *World Development Report 1987* conducted a study of 41 countries which shows that outward-oriented economies performed distinctly better than the inward-oriented economies in almost all respects. For instance, while the strongly outward oriented economies achieved a 7.7 per cent per annum growth rate of GDP in the period 1973-85, the strongly inward-oriented economies could manage a growth rate of only 2.5 per cent per annum during the period. Similar tendencies were observed in the case of other crucial indicators of development also like trends in per capita income, gross saving rate, incremental capital-output ratio, development of the manufacturing sector, price stability, growth of manufactured exports, etc. As far as the growth of manufacturing sector is concerned, average annual growth of manufacturing value added was 10.0 per cent in strongly outward-oriented economies during 1973-85 but only 1.3 per cent in strongly inward oriented economies.

In addition to the above, the *World Development Report* has argued that because of being exposed to external competition continuously, industries under outward-oriented strategy are more efficient and use their measures in the best possible way. As against this, inward-oriented strategy leads to inefficiency and resource misallocation as there is no pressure to perform well because of protection from imports.

Trade Policy Options for India. The message of the above discussion is clear enough—India should go in for globalisation and open up its economy considerably by liberalising the import-export regime. This would imply the conversion of quantitative restrictions to low and uniform tariffs, and the use of the exchange rate (rather than quantitative restrictions or tariffs) for bringing about balance of payments equilibrium.[9] There is a strong support for this policy among many economists and international financial institutions. In fact, the policy package offered by the World Bank and IMF to the developing countries facing balance of payments problems in the 1980s specifically included import liberalisation and a more 'open' trade and industrial policy as a condition for the grant of assistance. However, as is now well documented, several structural adjustment programmes (implying massive import liberalisation) introduced by the developing countries at the behest of the World Bank and the IMF have run into trouble. The reasons are not far to seek. While liberalisation of imports pushed up the import bill immediately, the export sector failed to respond at such a fast pace. This is due to the reason that favourable impact on exports can occur only after some time when resources have moved from non-tradeable to tradeable sectors. Therefore the deficits actually increased. It is thus obvious that such a programme can be undertaken only if adequate financing for a sufficiently long period is available. Even in countries like Japan, Korea and Taiwan which are the leading success stories of outward oriented strategy, import liberalisation was not done suddenly. In all these countries the post War period began with an initial phase of macroeconomic instability, followed by several years of stabilisation and import substituting growth and eventually by a turn to export led growth in the early 1960s.

Much more positive action is needed on the export front. ***Foreign Trade Policy (FTP) 2004-09 envisages a doubling of India's share in world exports from 0.75 per cent to 1.5 per cent by 2009.*** Bimal Jalan has advocated the following steps to achieve this target: *(i)* further reductions in tariff rates to international levels in order to remove the remaining bias against production for exports; *(ii)* allowing exporters to borrow abroad

at international rates as domezstic interest rates are substantially higher (which increase the cost of production and lower the expected returns from investments); *(iii)* creating special domestic financing facilities in term-lending institutions for export-related investments in a bid to insulate the exporters from high domestic interest rates; *(iv)* providing adequate and improved infrastructure for exporters; and *(v)* aggressive State intervention to promote exports (as is being done by most other countries, including industrial countries like Japan and USA). Such intervention should be strategic and should be directed at improving the domestic environment for exports and opening markets abroad. According to Jalan, while India has intervened heavily to promote exports in the past, the 'quality' of such intervention has been poor as compared with the policies pursued by successful exporters like Japan, Korea, Malaysia and China. "Unlike India, their intervention was strategic and not detailed. They encouraged competition in the domestic market; India fragmented its markets. India concentrated on identifying products and providing specific amounts of assistance on a case-by-case basis. The Japanese or the Korean system, on the other hand, was concerned with altering the generalised incentive framework in favour of exports rather than with specific products and specific markets."[10]

Exchange Rate Management

Exchange rate management plays a role complementary to trade policy. This is on account of the fact that exchange rate movements can be used for correcting the imbalances in the current account of the balance of payments. In India, prior to 1991, the rupee was pegged to the US dollar, pound sterling or a basket of currencies of India's major trading partners. In July 1991 when the Government of India announced major trade and industrial policy liberalisation measures, a two- step downward adjustment of 18-19 per cent was carried out in the exchange rate of the Indian rupee. This was expected to help the country in increasing the export earnings and thus in tackling the serious imbalances in the balance of payments. On the basis of the Report of the High Level Committee on Balance of Payments chaired by C. Rangarajan, the government introduced partial convertibility of rupee in 1992-93 Budget known as liberalised exchange rate management system (LERMS). This was followed by market determined exchange rate regime in 1993. ***The exchange rate is now largely determined by the market, i.e., demand and supply conditions. However, Reserve Bank intervenes to check excessive volatility in the market. Such an exchange rate regime is known as the 'managed float' regime.*** "The objective of exchange rate management has been to ensure that the external value of the rupee is realistic and credible as evidenced by a sustainable current account deficit and manageable foreign exchange situation. Subject to this predominant objective, the exchange rate policy is guided by the need to reduce excess volatility, prevent the emergence of destabilising speculative activities, help maintain adequate level of reserves, and develop an orderly foreign exchange market."[11]

Issues Pertaining to the Capital Account

In his article cited earlier, C. Rangarajan discusses three issues pertaining to the capital account: (1) external commercial borrowings, (2) NRI deposits, and (3) short-term debt.[12]

1. External Commercial Borrowings. Before 1980s almost the entire deficit in current account was financed by concessional assistance. However, in 1980s (particularly in the latter half of 1980s), dependence on external commercial borrowings increased significantly due to increasing shortage of concessional assistance. During 1990s also, the dependence of the country on external commercial borrowings was quite high. Since external commercial borrowings are obtained at high rates of interest, the dependence on high cost methods of financing increased. This represented a substantial future liability as too much dependence on external commercial borrowings can put extreme pressure on future generations unless the use of resources obtained through external commercial borrowings is highly productive and generates handsome foreign exchange earnings.

2. Non-Resident Deposits. During 1985-90, non-resident deposits accounted for 23 per cent of the financing need. In a large measure, the inflow of funds under these deposits was a response to conscious policy incentives in the forms of attractive interest rate differentials, exchange risk guarantees to banks and fiscal concessions.[13] However, just like external commercial borrowings, NRI deposits are also a high cost method of raising funds. Moreover, just like foreign institutional investors, the objective of non-residents is also to maximise returns. If conditions turn unfavourable, they are likely to withdraw funds from the country. Thus, both foreign institutional investors and non-residents are 'fair weather' friends.

3. Short-Term Debt. At times, countries resort to short term debt to bridge the balance of payments deficit. For instance, in India, short-term debt constituted 10 per cent of total external debt at end March 1990. However, this money is frequently 'hot-money' which moves across countries in search of high returns. Accordingly, too much dependence on such debt is a highly risky proposition and can land the country in

serious problem if there is a sudden withdrawal. On account of this reason, the Government of India has reduced its dependence on short-term debt considerably over the last few years. At end-March 2004, short-term debt was only 4.5 per cent of total external debt though it is estimated to have increased to 7.7 per cent of total external debt at end-March 2007.

External Debt

A country's external indebtedness is a 'mirror image' of the behaviour of the current account in the balance of payments. In this sense, the outstanding volume of India's external debt represents the accumulation of deficits in the current account over the past years. India's external debt was $ 83.8 billion at end March 1991 which rose to $ 155.03 billion at end March 2007. However, India's indebtedness position has improved over the period of the last 12-13 years. In 1991 India was the third largest debtor country after Brazil and Mexico while in 2004, it was the eighth largest debtor country. Debt service ratio which was 35.3 per cent at end-March 1991 dropped to 16.3 per cent at end-March 2004, to only 9.9 per cent at end-March 2006 and further to only 4.8 per cent at end-March 2007. Also, as noted above, the dependence on volatile short-term debt has declined.

Foreign Currency Reserves and Reserve Management Strategy

The payment crisis of 1991-92 underscored the acute problem of liquidity and international confidence that arises when foreign exchange reserves are depleted to finance overall deficits in the balance of payments. Accordingly, the Reserve Bank of India has attempted to build up adequate stocks of foreign exchange reserves to meet any contingencies arising out of the size of the current account deficit, short-term liabilities, the possible variability in portfolio investments and other type of capital flows, the unanticipated pressures on the balance of payments arising out of external shocks, movements in repatriable foreign currency deposits of non-resident Indians etc. It is now also realized that a sufficiently high level of reserves is necessary to ensure that even if there is prolonged uncertainty, reserves can cover the 'liquidity at risk' on all accounts over a fairly long period.

The level of foreign exchange reserves has increased considerably from US $ 5.8 billion at end-March 1991 to $ 97.6 billion at end-December 2003 and $ 240 billion in September 2007. The traditional measure of trade based indicator of reserve adequacy, *i.e.*, the import cover which shrank to three weeks of imports by the end of December 1990 has improved significantly to more than 12 month in 2006-07. According to the Reserve Bank, the foreign exchange position is presently comfortable on all other norms of adequacy as well. For instance, the ratio of foreign exchange reserves to external debt rose from 7.0 per cent in 1990-91 to 72 per cent in 2002-03 and further to 128.5 per cent in 2006-07. Thus, ***the foreign exchange reserves exceeded the external debt in March 2007*** (by as much as 28.5 per cent).

NOTES

1. Bimal Jalan, "Balance of Payments, 1956 to 1991", in Bimal Jalan (ed.), *The Indian Economy—Problems and Prospects* (New Delhi, 1992), pp. 163-4.
2. *Ibid.*, p. 172.
3. Government of India, *Economic Survey, 2006-07* (Delhi, 2007), p. 108.
4. *Business Standard,* March 13, 2007, p. 2.
5. Shankar Acharya, *Essays on Macroeconomic Policy and Growth in India* (New Delhi, 2006), p.16.
6. For details, please refer to the chapter on 'Foreign Investment, Technology and Multinational Corporations'.
7. C, Rangarajan, "India's Balance of Payments: The Emerging Dimensions", in C. Rangarajan, *Select Essays on Indian Economy* (New Delhi, 2004), p. 202.
8. *Ibid.*, p. 203.
9. Bimal Jalan, *India's Economic Crisis : The Way Ahead* (Delhi, 1991), p.125.
10. Bimal Jalan, *India's Economic Policy: Preparing for the Twenty First Century* (New Delhi, 1996), p. 100.
11. Reserve Bank of India, *Report on Currency and Finance,* 1998-99, p. XI-7.
12. C. Rangarajan, *op. cit.*, pp. 209-12.
13. *Ibid.*, p. 210.

CHAPTER

43 FOREIGN INVESTMENT, TECHNOLOGY AND MULTI-NATIONAL CORPORATIONS

Need for Foreign Capital
Components of Foreign Capital
Private Foreign Investment and MNCs
Organisation of Multinational Corporations
Reasons for the Growth of MNCs
Advantages of Private Foreign Investment
Indian Government's Policy towards Foreign Capital
Foreign Investment Inflows
A Critical Appraisal of Foreign Investment

Most of the underdeveloped countries suffer from low level of income and low level of capital accumulation. However, despite this shortage of capital, these countries have developed a strong urge for industrialisation and economic development. For instance, India launched upon an ambitious programme of industrialisation during the Second Plan. Since the domestic resources to carry out this programme were insufficient, the country had to depend on foreign capital.

In this chapter, we propose to discuss a number of issues related to foreign capital in general, and foreign investment, in particular. Since a major form of foreign direct investment is multinational corporations (MNCs), we shall also take up a detailed discussion on their role and functioning. The questions that we seck to address in this chapter are as follows:

- What is the role and importance of foreign capital and foreign investment in developing countries, with particular reference to India ?
- What has been the policy of Government of India towards foreign capital ? What changes have been made in this policy since 1991 to liberalise it ?
- What are MNCs ? What are the reasons for the growth of MNCs ?
- What are the criticisms of foreign investment ?

NEED FOR FOREIGN CAPITAL

Following arguments are advanced in favour of foreign capital :

1. Sustaining a high level of investment. Since the underdeveloped countries want to industrialise themselves within a short period of time, it becomes necessary to raise the level of investment substantially. This requires, in turn, a high level of savings. However, because of general poverty of masses, the savings are often very low. Hence emerges a resource gap between investment and savings. This gap has to be filled up through foreign capital.

2. The technological gap. The underdeveloped countries have low level of technology as compared to

the advanced countries. However, they possess a strong urge for industrialisation to develop their economies and to wriggle out of the low level equilibrium trap in which they are caught. This raises the necessity for importing technology from the developed countries. Such technology usually comes with foreign capital when it assumes the form of private foreign investment or foreign collaboration. In the Indian case, technical assistance received from abroad has helped in filling up the technological gap through the following three ways: (*a*) provision of expert services; (*b*) training of Indian personnel; and (*c*) educational, research and training institutions in the country.

3. Exploitation of natural resources. A number of underdeveloped countries possess huge mineral resources which await exploitation. These countries themselves do not possess the required technical skill and expertise to accomplish this task. As a consequence, they have to depend upon foreign capital to undertake the exploitation of their mineral wealth.

4. Undertaking the initial risk. Many underdeveloped countries suffer from acute scarcity of private entrepreneurs. This creates obstacles in the programmes of industrialisation. An argument advanced in favour of the foreign capital is that it undertakes the 'risk' of investment in the host countries and thus provides the much needed impetus to the process of industrialization. Once the programme of industrialisation gets started with the initiatives of foreign capital, domestic industrial activity starts picking up as more and more people of the host country enter the industrial field.

5. Development of basic economic infrastructure. It has been observed that the domestic capital of the underdeveloped countries is often too inadequate to build up the economic infrastructure on its own. Thus these countries require the assistance of foreign capital to undertake this task. In the latter half of the twentieth century especially during the last three-four decades, international financial institutions and many governments of advanced countries have made substantial capital available to the underdeveloped countries to develop their system of transport and communications, generation and distribution of electricity, development of irrigation facilities, etc.

6. The foreign exchange gap. In the initial phase of their economic development, the underdeveloped countries need much larger imports (in the form of machinery, capital goods, industrial raw materials, spares and components) than they can possibly export. As a result, the balance of payments generally turns adverse. This creates a gap between the earnings and expenditure of foreign exchange and it has to be filled up through foreign capital. As noted by Meier, ***"When the primary limit to development is the foreign exchange bottleneck, the productivity of aid is likely to be high: A relatively small increase in the availability of foreign exchange may yield a considerable increase in national income.*** By breaking a production bottleneck and allowing the utilization of previously underutilized capacity, the importation of strategic capital goods or foreign material provided by external aid can permit a sizable expansion of output from complementary domestic resources that would otherwise remain unused."[1]

COMPONENTS OF FOREIGN CAPITAL

Foreign capital takes two main forms: (1) private foreign investment, and (2) foreign aid. Private foreign investment can either be direct foreign investment or indirect foreign investment. As far as the direct foreign investment is concerned, the private foreign investor either sets up a branch or a subsidiary in the recipient country. Of particular importance has been the increasing role being played by the multinational corporations (MNCs) in the underdeveloped countries. These corporations have set up a large number of branches and subsidiaries in these countries and have brought with them new technological expertise, machinery and equipment, better management and organization, superior marketing techniques, etc. In fact, this is the main advantage of direct foreign investment. Indirect foreign investment or portfolio investment takes place when the nationals of one country purchase shares or debentures floated by industries in some other country. The Government of India presents data on foreign investment in the following categories: (1) Direct investment comprising (*a*) investment as approved by SIA (Secretariat for Industrial Approvals) and FIPB (Foreign Investment Promotion Board), (*b*) investment as approved by Reserve Bank of India, and (*c*) investment by Non-Resident Indians (NRIs); and (2) Portfolio investment comprising (*a*) GDRs (Global Depository Receipts), (*b*) investment by FIIs (Foreign Institutional Investors), and (*c*) off-shore funds and others.

Foreign aid can be defined to include "all official grants and concessional loans, in currency or in kind, which are broadly aimed at transferring resources from developed to less developed nations on developmental and/or income distributional grounds."[2] The chief characteristic of such aid is that it is made

available on concessional terms so that the interest rate is lower and the grace and maturity periods are longer. A small part of such aid is made available in the form of grants which do not carry any obligation of repayment. Foreign aid (in the form of grants and loans) is made available either by foreign governments or Foundations or international agencies like the International Development Association, World Bank, International Monetary Fund, etc.

In addition to grants and concessional loans, underdeveloped countries can also receive direct supplies of agricultural commodities (foodgrains, etc.) or industrial raw materials to face temporary shortages in the economy. The principal element in this form of aid is the U.S. contribution of surplus farm products under the provisions of Public Law 480. Aid in the form of technical assistance is also made available by the developed countries.

PRIVATE FOREIGN INVESTMENT AND MNCs

For a long period of time, private foreign investment was used by the colonial powers to exploit the colonies. The sectors that received such investment were mostly export sectors and this led to an 'enclave type' of development—a few developed sectors co-existing with a large number of backward and stagnant domestic sectors. Circumstances have changed rapidly in recent decades as more and more countries have won Independence. A phenomenon of particular importance in the developing countries of today is the rapid expansion of the activities of multinational corporations (MNCs). ***MNCs are huge industrial organisations which extend their industrial and marketing operations through a network of their branches or their Majority Owned Foreign Affiliates (MOFAs).*** MNCs are also known as Transnational Corporations (TNCs). Instead of aiming for maximization of their profits from one or two products, the MNCs operate in a number of fields and from this point of view, their business strategy extends over a number of products and over a number of countries. There are now some 40,000 TNCs whose tentacles straddle the international economy through 2,50,000 overseas affiliates. They possess staggering resources as would be clear from the fact that the sales of 200 top corporations in 1982 were equivalent of 24.2 per cent of the world's GDP and had risen to 28.3 per cent of world GDP in 1998. This shows that 200 top MNCs control over a quarter of the world's economic activity. In fact, the combined sales of these 200 MNCs estimated at $ 7.1 trillion in 1998 surpassed the combined economies of 182 countries. If we subtract the GDP of the big nine economies—the United States of America, Japan, Germany, France, Italy, the United Kingdom, Brazil, Canada and China—from the world's GDP, the GDP of the remaining 182 countries stood at $ 6.9 trillion in 1998 which was less than the sales of the 200 top MNCs. An idea of the giant size of these MNCs can also be had from the revelation made in a study conducted by the Washington based Institute for Policy Studies (IPS) that of the 100 largest economies in the world, 51 are corporations; only 49 are countries.[3]

ORGANISATION OF MULTINATIONAL CORPORATIONS

Subject to legal requirement, international agreements and commercial treaties, a multinational company can organise its operations in different countries through either of the following five alternatives: (1) Branches, (2) Subsidiary companies, (3) Joint venture companies, (4) Franchise holders, and (4) Turnkey projects.

Branches. The simplest form of extending business operations is to set up several branches. Legally, the branch is not an independent entity and is linked up to the parent company existing in some other country. The Companies Act, 1956 regards all those companies which are incorporated outside India and have set up their business in India as *foreign companies.*

Subsidaries. A multinational firm may also operate by setting up national affiliates as subsidiary companies. A subsidiary in a particular country is established under the laws of that country. Such subsidary companies take advantage of the financial and managerial skill of the holding company and also benefit by the international reputation that the latter enjoys. At the same time, they maintain their separate entity.

Joint Venture Companies. At times, MNCs enter into a joint venture with an indigenous firm or agency. Under this arrangement the MNC makes available machinery, capital goods and technological expertise to the indigenous firm. This form of organisation is adopted in those countries where the law requires control by local nationals. For instance, the law in a particular country may require that the local national must own a specified percentage of the affiliate's equity.

Franchise Holders. This is a special kind of arrangement by which an affiliate firm produces or markets the produce of a multinational firm after obtaining a licence from that firm. A formal contract is entered into between the affiliate firm and the multinational firm which specifically mentions the rights that are transferred to the affiliate firm and lays down the compensation (usually in the form of royalties) that it has to pay to the parent firm.

Turn-Key Projects. Under this organisational form, the multinational undertakes to complete the project from scratch to the operational stage. When the project is ready it is handed over to the host country. Frequently underdeveloped countries invite tenders for construction of certain projects requiring high technical skill. With their huge resources and managerial and technical expertise the MNCs are most suited to carry out this job.

Through these various methods of operations, MNCs carry their technology to the developing countries. If MNCs set up a branch or a subsidiary company, it is claimed that there is a direct injection of foreign experience and expertise in the developing country. The branch or the subsidiary company can provide a channel for the transmission of the latest improvements from the developed to the underdeveloped countries.

REASONS FOR THE GROWTH OF MNCs

Reasons for the growth of multinational corporations are manifold, the important ones being as follows:

1. Expansion of market territory. As the operations of a large-sized firm expand and as its international image builds up, it seeks more and more extension of its activities beyond the physical boundaries of the country in which it is incorporated.

2. Marketing superiorities. A multinational firm enjoys a number of marketing superiorities over the national firms : (*a*) It possesses a more reliable and uptodate market information system; (*b*) It enjoys market reputation and faces less difficulty in selling its products; (*c*) It adopts more effective advertising and sales promotion techniques; and (*d*) It has efficient warehousing facilities due to lower inventory requirements.

3. Financial superiorities. A multinational firm enjoys the following financial superiorities over the national firm: (*a*) It has huge financial resources with which it can easily turn all circumstances in its favour; (*b*) It maintains a high level of funds utilization by generating funds in one country and using them in another; (*c*) It has easier access to external capital markets; and (*d*) Because of its international reputation it is able to raise more international resources. Even investors and banks of the host country are eager to invest in it.

4. Technological superiorities. The main reason why MNCs have been encouraged by the underdeveloped countries to participate in their industrial development is on account of the technological superiorities which these firms possess as compared to national companies. The underdeveloped countries regard transfer of technology from MNCs useful on account of the following reasons: (*a*) Industrialization represents the most important way out of underdevelopment and the resources of these countries are insufficient to sustain the industrial progress on their own; (*b*) Local manpower, materials, local capital equipment etc. have to be optimally exploited and these countries are unable to accomplish this; (*c*) Depending totally on local companies would require heavy imports of raw materials, capital equipment, machinery and technical knowledge whereas MNCs bring these on their own; and (*d*) The underdeveloped countries have to face stiff competition for selling their products in international markets. Unless their goods meet international standards and quality specifications, they cannot sell. MNCs help them in producing such goods.

5. Product innovations. MNCs have huge Research and Development departments engaged in the task of developing new products and superior designs of existing products. While developing new products and superior designs of existing products, the MNCs have an eye on a number of countries. Therefore their production opportunities are far greater as compared to national companies.

ADVANTAGES OF PRIVATE FOREIGN INVESTMENT

The section on the 'Need for Foreign Capital' and the 'Reasons for the Growth of MNCs' mention some advantages of private foreign investment as well. In this section we propose to highlight some specific advantages of private foreign investment. These are as under:

1. Private foreign investment goes directly into capital formation and thus it constitutes a net addition to investible resources in the recipient country. Thus it helps in pushing up the rate of growth of the economy.

2. Being subject to business calculation of private profit it is likely to be employed more productively as compared to public financial aid.

3. When made available in the form of direct business investment (as in the case of investment by MNCs), foreign private investment promotes the spread of modern technology and efficient management methods.

4. Foreign investment may also induce more domestic investment. For instance, ancillary domestic units can be set up to 'feed' the main industrial unit set up by the foreign investor.

5. By setting an example, and through the training that they sponsor, foreign direct investments (as by MNCs) contribute to the transfer of technology to the underdeveloped countries and in encouraging the growth of skills.

6. Since returns on foreign investment are linked to the profits earned by the firm, it is more 'flexible' as compared to foreign loans which are guided by rigid interest and amortization requirements.

7. Foreign investment results in a pattern of growth which is desirable from the point of view of underdeveloped countries since new products are introduced and marketed, new tastes are created, and specific needs of the recipient country are met.

8. Free flow of capital is conducive both to total world welfare and to the welfare of each individual country. The operations of foreign firms, especially of modern multinational firms, knit countries together and closer into the web of international commerce, both by (internal and horizontal) economic integration and by the transmission of tastes, designs, ideas and technology.[4]

The real case for encouraging private foreign investment rests on whether it helps in raising productivity or not. If it does, and if the resulting increase is not wholly appropriated by the investor, the greater product must be shared with others. This would mean some direct benefits to other income groups. These benefits can accrue to (*a*) domestic labour in the form of higher real wages, (*b*) consumers by way of lower prices, and (*c*) the government through higher tax revenue. Beyond this, and most importantly in many cases, there are likely to be (*d*) indirect gains through the realisation of external economies.[5]

The pro-foreign investment arguments are not entirely correct and have been contested by various economists. It has been noted in a large number of countries that although foreign companies provide capital and thereby raise the level of capital formation in the short run, they have a tendency to lower domestic savings and investment rates by stifling competition, failing to reinvest most of the profit earned and inhibiting the expansion of indigenous firms. The management and technology provided by the MNCs rarely develop local sources of these scarce skills. According to Ragnar Nurkse, foreign business establishments have not shown much enthusiasm in imparting technical and managerial knowledge to the local population, unless compelled to do so by government regulations.[6] These and other drawbacks of foreign investment are discussed later in this chapter in the section 'A Critical Appraisal of Private Foreign Investment'.

INDIAN GOVERNMENT'S POLICY TOWARDS FOREIGN CAPITAL

At the time of Independence, the attitude towards foreign capital was one of fear and suspicion. This was natural on account of the previous exploitative role played by it in 'draining away' resources from this country. The suspicion and hostility found expression in the Industrial Policy of 1948 which, though recognizing the role of foreign investment in the country, emphasized that its regulation was necessary in the national interest. Because of this attitude expressed in the 1948 Resolution, foreign capitalists got dissatisfied and, as a result, the flow of imports of capital goods got obstructed. As a result, the Prime Minister had to give following assurances to the foreign capitalists in 1949:

1. **No discrimination between foreign and Indian capital.** The Government of India will not differentiate between the foreign and Indian capital. The implication was that the government would not place any restrictions or impose any conditions on foreign enterprise which were not applicable to similar Indian enterprise.

2. **Full opportunities to earn profits.** The foreign interests operating in India would be permitted to earn profits without subjecting them to undue controls. Only such restrictions would be imposed which also apply to the Indian enterprise.

3. **Guarantee of compensation.** If and when foreign enterprises are compulsorily acquired, compensation will be paid on a fair and equitable basis as already announced in government's statement of policy.

Though the Prime Minister stated that the major interest in ownership and effective control of an undertaking should be in Indian hands, he gave assurance that there would be "no hard and fast rule in this matter".

By a declaration issued on June 2, 1950, the government assured the foreign capitalists that they can remit the foreign investments made by them in the country after January 1, 1950. In addition, they were also allowed to remit whatever reinvestment of profit had taken place.

Despite the above assurances, foreign capital in the requisite quantity did not flow into India during the period of the First Plan. The atmosphere of suspicion had not changed substantially. However, the policy statement of the Prime Minister issued in 1949 and continued practically unchanged in the 1956 Industrial Policy Resolution, had opened up immense fields to foreign participation. In addition, the trends towards liberalization grew slowly and gradually more strong and the role of foreign investment grew more and more important. The government relaxed its policy concerning majority ownership in several cases and granted several tax concessions for foreign personnel. Substantial liberalisation was announced in the New Industrial Policy declared by the government in July 1991 and doors of several industries have been opened up for foreign investment. Prior to this policy, foreign capital was generally permitted (as a matter of policy) only in those industries where Indian capital was scarce and was not normally permitted in trading activities, plantations, banking and financial institutions. It was not permitted in those industries which had received government protection or which are of basic and/or strategic importance to the country. The declared policy of the government was to discourage foreign capital in certain 'inessential' consumer goods and service industries. However, this provision was frequently violated as a number of foreign collaborations even in respect of cosmetics, toothpaste, lipstick etc. were allowed by the government. It was also stated that foreign capital should help in promoting exports or substituting imports. The government also laid down that in all those industries where foreign capital investment is allowed, the major interest in ownership and effective control should always be in Indian hands (this condition was also often relaxed). The foreign capital investments and technical collaborations were required to be so regulated as to fit into the overall framework of the plans. In those industries where foreign technicians and managers were allowed to operate as Indians with requisite skills and experience were not available, vital importance was to be accorded to the training and employment of Indians in the quickest possible manner.

In a bid to attract foreign capital and investments from non-resident Indians (NRIs), the government has in recent years announced a number of tax concessions, lower rates of taxation for certain designated priority industries, tax holiday on profits for a certain period to new industrial undertakings etc. NRIs investing in India were allowed higher investment limits, priority allotment of items in short supply, permission to buy shares in Indian companies etc. However, ***the real 'opening up' came with the announcement of the new industrial policy in July 1991.*** In subsequent period, several other measures for promoting foreign investment have also been announced. ***FDI upto 100 per cent is now permitted on the automatic route[7] in all sectors/services except: (a) activities requiring industrial license under the Industries Development and Regulation) Act, (b) proposals where the foreign investor had an existing joint venture/technical collaboration/trademark agreement in the same field of activity, (c) proposals for acquisition of shares in an Indian company in the financial services sector and where SEBI (Substantial Acquisition of Shares and Takeovers) Regulation, 1997 is attracted and (d) all proposals falling outside notified sectoral policy/caps or under sectors in which FDI is not permitted.***

Some important measures announced for promoting foreign investment in the post-1991 period are as follows:

1. In 1991, the government announced a specified list of high technology and high-investment priority industries (listed in Annexure III) wherein automatic permission was granted for foreign direct investment (FDI) upto 51 per cent foreign equity. The limit was raised from 51 per cent to74 per cent and subsequently to 100 per cent for many of these industries. Moreover, many new industries have been added to the list over the years.

2. Prior to 1991 the government generally discouraged foreign equity holdings in service areas except for hotels. The 1991 policy invited foreign equity holdings upto 51 per cent by international trading companies. In addition to hotels, 51 per cent equity was also allowed in other tourist related areas.

3. A special empowered board has been constituted to negotiate with a number of large international firms and approve direct foreign inzvestment in select areas. There would be a special programme to attract substantial investment that would provide access to high technology and world markets. The investment programmes of such firms would be considered in totality, free from pre-determined parameters or procedures.

4. Hiring of foreign technicians and testing of indigenously developed technology abroad earlier required

case-by-case approval by the government. This involved unavoidable delay. This requirement has been waived and thus no permission is now required for these purposes.

5. To hasten the progress in the ailing power sector, the government (in a policy decision announced on July 31, 1991) allowed 100 per cent foreign equity participation for setting up power plants in the country. Hundred per cent foreign equity participation allows free repatriation of profits and other incentives.

6. NRIs, and overseas corporate bodies (OCBs) predominantly owned by them, have been allowed to invest upto 100 per cent equity in high-priority industries. These investments through the automatic approval route of RBI, have full benefits of capital repatriation. NRI investment upto 100 per cent of equity is also allowed in export houses, trading houses, star trading houses, hospitals, EOUs, sick industries, hotels etc. Foreign citizens of Indian origin are now permitted to acquire house property without the permission of the Reserve Bank of India.

7. Disinvestment of equity by foreign investors no longer needs to be at prices determined by the Reserve Bank. It has been allowed at market rates on stock exchanges from September 15, 1992 with permission to repatriate the proceeds of such disinvestment.

8. Foreign companies have been allowed to use their trade marks on domestic sales from May 14, 1992.

9. Foreign institutional investors can invest in a company under the portfolio investment route beyond 24 per cent of the paid up capital of the company with the approval of the general body of the shareholders by a special resolution. In the Union Budget for 2002-03, the Finance Minister announced that FII portfolio investments will not be subject to the sectoral limits for foreign direct investment except in specified sectors.

10. Foreign equity investments in Non-Banking Financial Companies (NBFCs) have been permitted in various categories of NBFC activities such as merchant banking, stock broking, venture capital, housing finance, foreign exchange broking, leasing and financing, financial consultancy, etc.

11. Foreign investors can set up 100 per cent operating subsidiares (without any restriction on number of subsidiaries) without the condition to disinvest a minimum of 25 per cent of their equity to Indian entities, subject to bringing in US $ 50 million.

12. In the process of liberalisation of FDI policy, the following policy changes have been made: (*i*) 100 per cent FDI permitted for business to business e-commerce; (*ii*) removal of cap on foreign investment in the power sector; and (*iii*) 100 per cent FDI permitted in oil refining.

13. Automatic route is available to proposals in the Information Technology sector, even when the applicant company has a previous joint venture or technology transfer agreement in the same field.

14. FDI upto 100 per cent is allowed with some conditions for the following activities in the telecom sector: (*i*) Internet service providers (ISPs) not providing gateways; (*ii*) Infrastructure providers providing dark-fiber; (*iii*) electronic mail; and (*iv*) voice mail.

15. FDI cap has been increased from 49 per cent to 74 per cent in basic and cellular telecom services. The revised cap includes both FDI and portfolio investment.

16. Foreign firms have been allowed to pay royalty on brand name/trade mark as a percentage of net sales in case of technology transfers.

17. FDI upto 26 per cent is eligible under the automatic route in the insurance sector, as prescribed in the Insurance Act, 1999, subject to their obtaining licence from Insurance Regulatory and Development Authority (IRDA).

18. FDI upto 100 per cent is permitted in airports, with FDI above 74 per cent requiring prior approval or the government.

19. FDI upto 100 per cent is permitted with prior approval of the government in courier services subject to existing laws and exclusion of activities relating to distribution of letters.

20. FDI upto 100 per cent is permitted with prior approval of the government for development of integrated townships and regional urban infrastructure, tea sector (including tea plantation), advertising and films.

21. FDI upto 100 per cent is permitted on the automatic route in hotel and tourism sector and for Mass Rapid Transport Systems in all metropolitan cities, including associated commercial development of real estate.

22. The defence industry sector has been opened upto 100 per cent for Indian private sector participation with FDI permitted upto 26 per cent, both subject to licensing.

23. In January 2004, the government raised FDI limit to 100 per cent in petroleum sector. For example,

FDI upto 100 per cent was allowed in petroleum product marketing through automatic route (raised from 74 per cent); FDI upto 100 per cent was allowed for petroleum products pipelines and for natural gas/LNG pipelines (raised from 51 per cent); and FDI upto 100 per cent was allowed through automatic route in oil exploration in small and medium sized fields.

24. In January 2004, the government allowed FDI upto 100 per cent in printing scientific and technical magazines, periodicals and journals.

25. Foreign investment in the banking sector has been further liberalised by raising FDI limit in private sector banks to 74 per cent under the automatic route including investment by FIIs (foreign institutional investors). The aggregate foreign investment in a private bank from all sources will be a maximum of 74 per cent of the paid up capital of the bank and at all times, at least 26 per cent of the paid-up capital will be held by residents except in regard to a wholly owned subsidiary of a private bank.

26. ***Press Note 18 which placed various restrictions on foreign investors/companies setting up business in India was scrapped in January 2005.*** The Press Note 18 stated that if a foreign company has a joint venture in India, the application was required to be routed through the FIPB (Foreign Investment Promotion Board). This, in fact, meant that the foreign investors were required to give the detailed circumstances under which they found it necessary to set up a new joint venture or enter into new technology transfer. The foreign investors regarded Press Note 18 as a hurdle. According to the fresh guidelines issued on January 12, 2005, automatic route is available for new proposals for FDI provided the proposed activity is on the automatic route and the foreign investor did not have an existing joint venture/collaboration in the same field.

27. Conversion of external commercial borrowing/loan into equity has been allowed under the automatic route provided the activity is covered under the automatic route and the foreign equity after such conversion falls within the sectoral cap.

28. Conversion of preference shares into equity shares has been allowed under the automatic route provided the increase in foreign equity participation is within the sectoral cap in the relevant sectors and the activity is under the automatic route.

29. FDI upto 51 per cent with government approval for retail trade of 'Single Brand' products has been allowed.

30. The requirement of mandatory disinvestment of 26 per cent foreign equity in B2B-e Commerce has been dispensed with.

FOREIGN INVESTMENT INFLOWS

As correctly pointed out by R. Nagaraj, to understand how the recent changes in foreign investment policy have influenced the economy, quantitative information is needed on broad dimensions of the investment (and its distribution) across industries, regions and by size of projects; firm and industry level production accounts, and audited financial statements. However, such information is scarce. The most easily available (and widely used) data in India are on FDI approvals by broad industry groups, by country of origin, and by States (regions) of destination. However, this represents mere 'intentions' of investment. The actual (or realised) foreign investment is not available by the same classification, but according to the administrative and institutional channels of inflow. Therefore, it is not possible to compare the 'realised' foreign investment with the 'intentions,' in any meaningful manner.[8] Moreover, argues Nagaraj, even the concerned official agency does not seem to know —let alone monitor — how the actual inflows are translated into capital formation, transfer of assets or change in managerial control.

Foreign Investment Flows by Category. Before we consider trends in foreign investment, it is necessary to point out that the data since 2000-01 are not comparable to the data prior to this year. This is on account of the change in the definition of foreign investment in an attempt to bring it in line with international practices. In India, FDI inflow was recorded under five heads: (*i*) Reserve Bank of India's automatic approval route for equity holding upto 51 per cent; (*ii*) Foreign Investment Promotion Board's or Secretariat of Industrial Approval's discretionary approval route for larger projects with equity holding greater than 51 per cent; (*iii*) acquisition of shares route since 1996 (relating to acquisition of shares of Indian companies by non-residents under Section 29 of FERA); (*iv*) RBI's non-resident Indian (NRI) schemes; and (*v*) external commercial borrowings (American Depository Receipts/Global Depository Receipts and euro equities). This definition differed from that of the IMF which includes external commercial borrowings, reinvested earnings and subordinated debt. In an effort

BOX 43.1. The Business of P-Notes

What are P-Notes?

- P-Notes are instruments issued by FIIs (foreign institutional investors) to enable foreign investors trade in stocks without disclosing their identity.
  Thus, P-Notes are essentially overseas derivative instruments, issued to investors who are either not registered in India or are not interested in registering. Their underlying assets can be Indian equity, debt or exchange-traded derivatives. Simply put, investors who are not eligible to invest in India or do not want to register themselves are trading in Indian equity, debt and derivatives.
- P-Notes have been allowed by SEBI (Securities and Exchange Board of India) since February 2000 to enable foreign companies and high net-worth investors invest in the Indian market.

Extent of P-Notes

- P-Notes have contributed a substantial proportion of FII inflows during the last few years. The notional value of PNs has grown by more than 11 times since March 2004 to roughly $ 88 billion (as of August 2007), or 51.6 per cent of all AUC (assets under custody) of FIIs or their such-accounts.
- In rupee terms, P-Notes have grown from Rs. 31,875 crore in March 2004 to Rs. 3,53,484 crore in August 2007.

Risk Factors

- The identity of sub-accounts and holders of PNs is not known (hence opaque). Such 'anonymous investment' reduces the financial discipline that a regulator must impose on the market.
- Through these routes, entities not expected to play a role in the Indian market can have a significant influence on market movements. These unregulated and unidentified entities can play hovoc with the market through their speculative activities, particularly because they are a source of large FII flows.
- These instruments are not only heavily traded in but FIIs and their sub-accounts issue securities based on the notional value of P-Notes. In a chain of investors, even if one investor goes bust, he starts selling the securities, of which the underlying asset is the derivative. And since FII inflows follow a herd mentality, this is likely to trigger a massive sell off in the derivatives market resulting in falling valuations in the cash market. Since a large chunk of domestic investment is in cash market, such selling can jeopardise it.
- The ultimate investor of a PN is not identified and some of the PNs may be associated with illegal activities such as smuggling or the drugs trade or terror networks.

Curbs on P-Notes

The country's stock market regulator SEBI has announced it intention to phase out P-Notes. With this end in view, it announced various curbs on October 25, 2007 :

- FIIs and their sub-accounts, vehicles set up by registered FIIs to issue PNs, are no longer allowed to issue PNs whose underlying asset is a derivative. Their positions must be wound up over 18 months. However, sub-accounts applying for an FII status could continue business with their application pending.
- SEBI imposed a PN issuance limit of 40 per cent of assets under custody (AUC). Entities below 40 per cent would be allowed an annual 5 per cent incremental increase capped at 40 per cent and those above 40 per cent had to stop at the level they had reached.
- Issuance of PNs will be limited to entities that are 'regulated' in their home countries. This could mean that many unregulated hedge funds that have invested in Indian markets cannot buy Indian shares through such PNs.

Pros and Cons of SEBI Norms

- To improve accessiblity to Indian markets for foreign investors, unregulated entities such as pension funds, foundations, endowments, university funds, and charitable trusts and societies, will be allowed to register as FIIs. This will encourage direct participation from pension funds, endowments, university funds and charities.
- A one-year track record of the fund seeking SEBI registration as an FII will not be considered; only performance of fund manager will be taken into account. This will make registration easier.
- The limit for a single investor in an account has been increased from 10 per cent to 49 per cent.
- Proprietary or corporate sub-accounts that have applied for FII registration can continue with business as usual.
- Entities — primarily the cash-heavy hedge funds — that are not regulated in their country of origin will not have a window to PNs, with immediate effect. What's more, they will also have to unwind their positions in the coming 18 months.
- With the new regulations in place, SEBI will be in the position to 'put a face' to every investor coming into the country. Thus the problems associated with opaqueness of PNs will be tackled. The effort of SEBI is to convert the sub-accounts and proprietory accounts of FIIs so that all the money that comes in is through regulated entities governed by Know Your Client (KYC) norms.
- Short-term flows can be impacted because people who are not registered with SEBI as FIIs will have to unwind their position in the next 18 months. Of the total P-Notes, 30 per cent (Rs. 1.17 lakh crore) of P-Notes have derivatives as their underlying.

Source : ***(i)*** **"SEBI Stays Firm : PNs Headed Out",** ***mint,*** **October 26, 2007, pp. 1-3;** ***(ii)*** **"Purging the P-Note",** ***India Today,*** **November 5, 2007, pp. 28-30; (iii) "Fresh lease of life",** ***Business Today*** **November, 18, 2007, pp. 58-9.**

to bring the Indian definition in line with IMF's definition, the coverage of FDI since 2000-01 includes, besides equity capital (i.e., RBI automatic route, SIA/FIPB route, NRI and acquisition of shares), reinvested earnings (including earnings of FDI companies) and other direct capital (inter-corporate debt transactions between related entities). As a result of this revision in definition of FDI while FDI in 2000-01 according to earlier definition of FDI was $ 2,339 million, it is now estimated at $ 4,029 million. Similarly, estimate of FDI in 2001-02 has increased from $ 3,904 million to $ 6,131 million. In Table 43.1, data on FDI prior to 2000-01 are presented on the basis of the earlier definition while data since 2000-01 are presented on the basis of the new definition. Adding estimates of FDI to the estimates of portfolio investments, gives estimates of total foreign investment flows into the country.

TABLE 43.2. Foreign Investment Flows to India by Category

(US $ million)

	1991-92	1993-94	1998-99	1999-2000	2000-01	2004-05	2005-06	2006-07(P)
A. **Direct Investment** *of which*	**129**	**586**	**2,462**	**2,155**	**4,029**	**6,051**	**7,722**	**19,531**
a. SIA/FIB route	66	280	1,821	1,410	1,456	1,062	1,126	2,156
b. RBI automatic route	—	89	179	171	454	1,258	2,233	7,151
c. Non-Resident Indians	63	217	62	84	67	—	—	—
B. **Portfolio Investment**	**4**	**3,567**	**–61**	**3,026**	**2,760**	**9,315**	**12,492**	**7,003**
a. GDRs/ADRs and euro equities	—	1.520	270	768	831	613	2,552	3,776
b. Foreign institutional investors	—	1,665	–390	2,135	1,847	8,686	9,926	3,225
c. Offshore Funds & Others	4	382	59	123	82	16	14	2
Total = (A + B)	**133**	**4,153**	**2,401**	**5,181**	**6,789**	**15,306**	**20,214**	**26,534**

P: Provisional

Source: (*i*) Government of India, *Economic Survey*, 2002-03 Delhi, 2003), Table 6.10, p. 119; and (*ii*) *Reserve Bank of India, Annual Report*, 2006-07 (Mumbai, September 2007), Table 1.83, p. 94.

As is clear from Table 43.1, there has been massive increase in foreign investment inflows into the country since 1991-92 (both as a consequence of increases in FDI and portfolio investment). From $ 133 million in 1991-92, foreign investment inflows rose to $ 4,153 million in 1993-94, i.e., in just a span of two years basically due to rapid increase in portfolio investment. Foreign investment inflows reached a peak of $ 6,133 million in 1996-97 because of impressive increases in both FDI and portfolio investments but declined thereafter. In 1998-99, there was an outflow of funds amounting to $ 390 million by FIIs (foreign institutional investors) with the result that overall portfolio investment was negative. However, portfolio investment recovered strongly in the very next year to $ 3,026 million. Since FDI inflows in this year were $ 2,155 million, the overall foreign investment inflows rose to $ 5,181 million. As stated above, higher levels of FDI witnessed since 2000-01 are partly due to the revised definition of FDI. In terms of the revised definition, FDI rose to $ 4,029 million in 2000-01 and further to $ 5,035 million in 2002-03. The year 2003-04 registered massive foreign investment inflows of $ 15,699 million basically because of hike in investment by foreign institutional investors (from just $ 377 million investment by FIIs in 2002-03, this investment rose to as high as $ 8,686 million in 2004-05). According to Reserve Bank, this reflected investors' confidence in the Indian economy. Foreign investment inflows amounted to $ 15,366 million in 2004-05 and $ 20,214 million in 2005-06. Investment by FIIs again contributed a significant proportion of these investment inflows (the share of FIIs in total investment inflows being 56.5 per cent in 2004-05 and 49 per cent in 2005-06). However, a distinct change occured in the year 2006-07 with FDI recording a substantial increase (from $ 7,722 million in 2005-06 to 19,531 million in 2006-07). According to Reserve Bank, ***the reasons for the sharp increase in FDI in 2006-07 were 'expansion in domestic activity, positive investment climate, progressive liberalisation of the FDI policy regime, and simplification of procedures. The rising pace of mergers and acquisitions in sectors such as financial services, manufacturing, banking services, information technology and construction also boosted FDI inflows.***[9] FDI inflows in 2006-07 accounted for almost three fourths of total foreign investment flows to India ($ 19,531 million out of 26,534 million).

According to the Reserve Bank, ***among the developing countries, India has now emerged as the second most preferred FDI destination after China. India's share in global FDI flows increased from 2.3 per cent in 2005 to 4.5 per cent in 2006.***[10]

Sources of FDI. ***Largest inflows of FDI over the period 1991-92 to March 2006 have been received from Mauritius, its share in these inflows being as high as 37.8 per cent.*** USA was second with a share of 15.25 per cent. However, it should be noted here that Mauritius based investments are nothing but US investments. They are routed through Mauritius because of the tax advantages. The tax advantage emanates from the double tax avoidance agreement that India has with that country. This agreement means that any foreign investor has

the option of paying tax either in India or in Mauritius. Since the tax rates prevailing in Mauritius are amongst the lowest in the world, many multinational corporations prefer to route their investments to India through Mauritius. Other important sources of FDI in India are Japan, Netherlands, UK, Germany, Singapore, France, South Korea and Switzerland.

While discussing the sources of FDI in India it is necessary to point out the changes in sources that have taken place in the period of 1990s. While prior to 1990s, India had to depend on a few developed Western countries for capital, during 1990s a number of other countries have evinced interest in investing in India. These include countries like Italy, Australia, South Korea, Malaysia, Singapore etc. Many other countries like Israel, Thailand, Saudi Arabia, South Africa, etc. whose names did not appear in the FDI list prior to 1991 have gone on to increase their stake steadily over the years.

Sectoral Composition of FDI. Considering the sectoral composition of FDI over the period August 1991 to September 2006, one finds that the largest recipient of such investment was the sector of electrical equipment (including computer software and electronics). The share of this sector in cumulative FDI inflows over the period was 17.54 per cent (i.e., one-sixth). It was followed by services sector (share 12.69 per cent), telecommunications industry (share 10.39 per cent), transportation industry (share 9.31 per cent), power and oil refinery (share 7.45 per cent), chemicals excluding fertilisers (share 5.79 per cent), food processing industries (share 3.12 per cent), drugs and pharmaceuticals (share 2.91 per cent), metallurgical industries (share 2.14 per cent) and cement and gypsum products (share 2.14 per cent). In fact, ***these ten sectors accounted for more than 70 per cent of the FDI in India.***

A CRITICAL APPRAISAL OF FOREIGN INVESTMENT

Foreign investment has a number of disadvantages and in some cases its costs might considerably exceed its benefits to the recipient country. The operations of MNCs open up the possibilities of interference in the industrial (and other) activities of the recipient country and are thus resented to by 'nationalist' thinkers. The main arguments against (and harmful effects of) foreign investment are as under:

1. Special concessions to the foreign investors. The governments of the developing countries have to provide special facilities and concessions to the foreign investors to attract them. These may include tax concessions, provision of subsidized inputs, financial assistance, freedom to remit profits in foreign exchange despite tight foreign exchange position, etc. In fact, if the country is facing an adverse balance of payments position and an acute foreign exchange crisis, finding foreign exchange sufficient for the remittance of profits might pose a serious problem. Measures such as import quotas, tariffs, exchange restrictions etc. may suppress the demand for imports, but they do so at the cost of productivity and efficiency.

2. Payments of dividends and royalty. A large sum of money flows out of the country in terms of payment of dividends, profits, royalties, technical fees and interest to the foreign investors.

3. Elitist orientation of production. Foreign investment (particularly by MNCs) is more interested in quick-profit yielding consumer goods sector. Thus its emphasis is on producing goods for the cash-rich but small elite sector of the developing countries like cosmetics and toiletery items, colour televisions, music systems, cellular phones, luxury cars etc. This leads to diversion of scarce economic resources to the production of non-essential items.

4. Agreements loaded in favour of foreigners. The terms of agreements are mostly weighted in favour of the foreign collaborators and against the domestic interests. This is due to the weak bargaining power of the developing countries and the eagerness of their governments to acquire foreign participation in the face of foreign exchange shortage.

5. Multiple collaborations and over-import of equipment. At times, the governments of the developing countries permit multiple collaborations, i.e., repetitive import of the same or similar technology. This results in repetitive payments without adding to the stock of technical knowledge in the country. Moreover, since the responsibility of specification and supply of equipment is generally entrusted to the foreign collaborators, there is a close tie-up between the designers and suppliers resulting not only in price mark-up but also in over-import of equipment. Sometimes equipments are imported even when they are available locally, sometimes they remain idle for want of spares, and often the processes are more highly mechanised and sophisticated than is warranted by the requirements of the domestic country.

6. Restrictive clauses in agreements. The most important criticism of foreign collaboration agreements is the presence of various restrictive clauses in them. For example, the Fourth Survey of Foreign Collaborations

(1985) carried out by the Reserve Bank of India showed that as many as 72.3 per cent of purely technical agreements had restrictive clauses in them. Some of the restrictions imposed in these agreements were: (*a*) the technology cannot be passed on to any one else, in some cases even after the expiry of the agreement; (*b*) manufacturing is to be carried out according to the specifications laid down by the collaborator and no local adaptations can be made; (*c*) control over overseas purchase was exercised through the provision that it had to be made directly or indirectly through the collaborator; (*d*) production was tightly controlled at times through the posting of foreign technicians; (*e*) controls over the pricing and marketing of the products were exercised by requiring that a part of the production was to be sold to collaborator's subsidiary in India at a fixed commission or that specified firms were to be made the sole selling agents; and (*f*) right to export was also restricted by the provision that exports could be done only to specific countries or on certain preconditions.

7. Distortion of economic structure. Foreign investment (particularly by MNCs) can inflict heavy damage on the host country in various forms such as suppression of domestic entrepreneurship, extension of oligopolistic practices (such as unnecessary product differentiation, heavy advertising, or excessive profit taking), supplying the economy with unsuitable technology and unsuitable products, helping the growth of monopolies and concentration of economic power thereby worsening the income distribution etc.

8. Foreign resources used to acquire existing assets. A worrisome feature is the nature of deployment of foreign resources. For example, in his study on foreign direct investment in India during the period of 1990s, R. Nagaraj has argued that almost 40 per cent of the inflows seem to have been utilised for acquiring existing industrial assets and their managerial control.[11] This shows that ***a substantial part of foreign resources is not going into fresh capital formation but in mergers and acquisitions.*** Many MNCs are taking advantage of liberal rules to increase their stakes in their existing affiliates in the country while a large number of MNCs are opting the route of acquisition of existing enterprises to enter India. Such tendencies do not promote industrial expansion and competition but only result in change in management. Policies with regard to investment by NRIs are similarly flawed. In this context, Martinussen observes, "The focus on attracting rentiers—NRIs especially—to hold portfolio investments in India has not contributed much to real capital formation, it merely implied that ownership of existing income-bearing assets have changed hands."[12]

9. Increase in regional inequalities. Delhi, Maharashtra, Dadra and Nagar Haveli, Daman and Diu, Haryana and selected parts of Uttar Pradesh and Karnataka have received more than half of FDI inflows. A large part of the country has received only negligible parts of such inflows. Thus FDI has accentuated regional disparities still further.

10. Political interference. Because of their immense financial and technical power, the MNCs have gained necessary strength to influence the decision making processes in underdeveloped countries. Though they do help in transferring technology to underdeveloped countries, it has been often found that models and patterns of industrial development and technologies transferred are not in harmony with the interests of the host countries. The governments of underdeveloped countries have also felt threatened by the direct and indirect interference of MNCs in their internal affairs. The autonomy and sovereignty of the host countries is in danger. Because of these reasons, the governments of various countries have sought to restrict the activities of MNCs in their economies through a battery of administrative controls and legal provisions.

11. Technology transfer not necessarily conducive to development. As far as transfer of technology to underdeveloped countries in concerned, the behaviour pattern of MNCs reveals that they do not engage in R and D activities within the underdeveloped countries. Their R and D efforts are concentrated in laboratories in the home country or in other industrialised countries. Though R and D activities continue to be centralized in the parent country, the host countries have to bear the bulk of their costs since the affiliates of the MNCs in these countries remit payments on this account generally in relation to their sales volume. Such payments by the affiliates are generally over and above those remitted in the form of royalties and technical fees to the parent firm. The satisfaction expressed on technology transfer is partly misconceived also on account of the fact that MNCs which generally command a semi-monopolistic position in their product lines do not transfer their first-line or most advanced technology until foreign firms compel them to do so. ***In many cases, the technology transferred is of a capital-intensive nature which is not useful from the point of view of a labour surplus economy.*** In fact, continued insistence on the import of such technology can have serious consequences for the economy of the host country since unemployment will increase. Also, market will fail to grow and this constraint alone would suffice to restrain the rate of growth from increasing.

Box 43.2 reproduced from Todaro and Smith summarizes the debate about MNCs in terms of seven key issues and a range of questions that surrounds each of them : international capital movements, displacement

of indigenous production, extent of technology transfer, patterns of consumption, social structure and stratification, and income distribution and dualistic development.

BOX 43.2. Role and Impact of MNCs In Developing Countries—Seven Key Disputed Issues

Key Issue	*Sources of Dispute*
1. International capital movements (income flows and balance of payments)	a. Do they bring in much capital (savings) ?
	b. Do they improve the balance of payments ?
	c. Do they remit "excessive" profits?
	d. Do they employ transfer pricing and disguise capital outflows?
	e. Do they establish few linkages to the local economy?
	f. Do they generate significant tax revenues?
2. Displacement of indigenous production	a. Do they buy out existing import-competing industries?
	b. Do they use their competitive advantages to drive local competitors out of business?
3. Extent of technology transfer	a. Do they keep all R&D in home countries?
	b. Do they retain monopoly power over their technology?
4. Appropriateness of technology transfer	a. Do they use capital-intensive technologies?
	b. Do they adopt technology to local factor endowments or leave it unchanged?
5. Patterns of consumption	a. Do they encourage inappropriate patterns of consumption through elite orientation, advertising, and superior marketing techniques?
	b. Do they increase consumption of their products at the expense of other (perhaps more needed) goods?
6. Social structure and stratification	a. Do they develop allied local groups through higher wage payments, hiring (displacing) the best of the local entrepreneurs, and fostering elite loyalty and socialization through pressures for conformity?
	b. Do they foster alien values, images, and lifestyles incompatible with local customs and beliefs?
7. Income distribution and dualistic development	a. Do they contribute to the widening gap between rich and poor?
	b. Do they exacerbate urban bias and widen urban-rural differentials?

***Source*: Michael P. Todaro, and Stephen C. Smith, *Economic Development* (Pearson Education Asia, Eighth edition, 2003), Table 15.3, p. 643.**

NOTES

1. Gerald M. Meier, *The International Economics of Development* (New York, 1968), p. 102.
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3. Nivedita Prabhu, "The Numbers are up in the 200 Club", *The Economic Times,* October 4, 1998, p. 1.
4. Sanjaya Lall "Less-Developed Countries and Private Foreign Investment", *Economic and Political Weekly,* August 3, 1974, p. 1241.
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6. Ragnar Nurkse, *Problems of Capital Formation in Underdeveloped Countries* (Delhi, 1973). p. 88.
7. Automatic approval reduces the scope of discretionary use of powers by the FIPB (Foreign Investment Promotion Board).
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UNIT 7

Labour Environment in India

44. Features of Indian Labour Market
45. Industrial Labour
46. Implications of Economic Reforms for Labour Markets in India
47. Workers' Participation in Management

No institution, be it the MNC, civil organisation, or government, can create wealth unilaterally at the bottom of the pyramid. Wealth creation must engage the poor.

— C.K. Prahalad

CHAPTER

44 FEATURES OF INDIAN LABOUR MARKET

Concept of Labour Market
Agricultural Labour Market in India
• Definition of Agricultural Labour • Growth in the Number of Agricultural Workers • Characteristics of Agricultural Labour Market
Industrial Labour Market
• Characteristics of Industrial Labour Market
Tertiary Labour Market
• Expansion of Tertiary Labour Market • Characteristic of Tertiary Labour Market

In this chapter, we propose to discuss the following questions:

- What is a labour market ? What are the features of a labour market that distinguish it from a commodity market ?
- What is the meaning of agricultural labourers ? What are the characteristics of agricultural labour market in India ?
- What are the characteristics of (*i*) industrial labour market, and (*ii*) tertiary labour market in India ?

CONCEPT OF LABOUR MARKET

From a theoretical point of view, labour market may be defined as "***a process by which supplies of a particular type of labour and demands for that type of labour balance or seek to obtain a balance***." The labour market is the place for the operation of this process. Labour market is also defined as "a manufacturing and trading centre plus the agricultural hinterland directly tributary to it."

There is a tendency among some economists to treat labour market at par with commodity market in the sense that the price of labour (wage) is determined by the forces of supply and demand just as the price of a commodity is determined by the forces of supply and demand. However, there are some specific features of a labour market that distinguish it from a commodity market. Some of these features are as follows:

1. Immobility of labour. Labour obvisouly cannot move with the same ease and facility that commodities can move. Therefore ***lack of mobility is an important characteristic of the labour market.*** This lack of mobility can be explained by the reluctance of labourers to leave their families and move from place to place in search of job opportunities. In some cases, the workers are not even aware of alternative job opportunities at other places or they may prefer the existing jobs having security to alternative jobs presenting better wages but no security. There is another problem. Different jobs require different skills and it is not easy to shift occupations in response to changes in wages and salaries. Therefore mobility of labour is restricted.

2. Labour market is essentially a local market. Because of the lack of mobility of labour, ***labour market is essentially a local market.*** Another factor that contributes to the local character of labour market is the fact that this market covers such of the buyers and such of the sellers who communicate among themselves

in order to settle a bargain for employment at a certain wage. Those who do not participate in the bargain will not be a part of the market. Accordingly, the labour markets are often local markets in the sense that the demand for and supply of labour are confined to a certain locality.

3. Relationship between buyer and seller is not impersonal. Another distinguishing feature of the labour market is that ***the relationship between the seller of labour and its buyer is not impersonal and temporary.*** Such relationship is governed by many social and economic considerations and is often permanent rather that casual and temporary. For example we know that families of agricultural labourers in Indian rural areas have been attached to zamindars and landlords for decades together. In fact, the 'bond' passes from generation to generation.

4. Labour market is an imperfect market. Because of the above reasons, ***wage rates for the same work and the same category of labour are not uniform across the regions of the same country*** despite the fact that there are no political barriers to the movement of labour. In fact, wages for the same kind of job can vary significantly across regions. Nor is it possible for the relative abundance of labour in a particular region of the country to pull down the wage level in another region having a relative shortage of labour. Another evidence of labour market imperfection can be found in the fact that there is no 'normal' wage rate in this market to which the market rate naturally tends.

5. Better bargaining strength of employers. Because of the fact that labour is abundant (particularly in labour surplus economies like India) whereas buyers of its services are relatively much less, ***the bargaining strength of labour is much weaker.*** Frequently, in a particular place or locality, the number of employers is limited because the means of production are concentrated in a few hands. Therefore they can even combine amongst themselves to forge a common wage policy. As against this, the number of workers is much larger and they are mostly unorganised and disunited. As a result, their bargaining power is much less. To overcome this disadvantage, industrial labourers have formed trade unions in recent decades. A trade union fights for protecting the interest of labour and serves as an instrument of collective bargaining with the employers. However, agricultural labourers continue to be unorganised and disunited and therefore more prone to exploitation at the hands of the employers.

AGRICULTURAL LABOUR MARKET IN INDIA

Agricultural labour market in India is characterised by excess supply of labour leading to low agricultural wages on the one hand, and widespread prevalence of disguised unemployment[1] on the other hand. Even the persons who are employed as agricultural labour face irregular employment because of the seasonal nature of agricultural operations. Since they possess no skill or training, they have no alternative employment opportunities either. Socially, a large number of agricultural workers belong to scheduled castes and scheduled tribes. Therefore, they are an oppressed class.

They are not organised and cannot fight for their rights. Because of all these reasons, their economic lot has failed to improve even after five and a half decades of planning. It seems that (excepting pockets in some agriculturally prosperous regions of the country), the planning process has bypassed them.

Definition of Agricultural Labour

Unlike industrial labour, agricultural labour is difficult to define. The reason is that unless capitalism develops fully in agriculture, a separate class of workers depending wholly on wages does not come up. Since the capitalist relations are in an underdeveloped state in India, such clear-cut class of agricultural workers has not yet evolved. Difficulties in defining agricultural labour are compounded by the fact that many small and marginal farmers also work partly on the farms of others to supplement their income. To what extent should they (or their family members) be considered agricultural labourers is not easy to answer.

Despite these difficulties, various attempts have been made to define agricultural labour by different experts and committees appointed by the government from time to time. The first Agricultural Labour Enquiry Committee of 1950-51 regarded those people as agricultural workers who were engaged in raising crops on payment of wages. Since in India, a large number of workers do not work against payment of wages all the year round, this definition was incomplete. Accordingly, the Committee laid down that those people should be regarded as agricultural workers who worked for 50 per cent or more days on payment of wages. Therefore, even those people were included under the category of agricultural workers who possessed some land or were rural artisans but who worked 50 per cent or more days on the land of others against payment of wages. The

Committee also defined an agricultural labour household. In the opinion of the Committee, if the head of household or 50 per cent or more of the earners report agricultural labour as their main occupation, that family should be classified as an agricultural labour household. The Second Agricultural Labour Enquiry Committee of 1956-57 took a broad view of agricultural activities to include those workers also who were engaged in allied activities like animal husbandry, poultry, piggery, etc. The Second Committee submitted that to know whether a household is an agricultural labour household we must examine its main source of income. If 50 per cent or more of its income is derived as wages for work rendered in agriculture, only then it could be classified as agricultural labour household. The changeover from 'work' to 'income' seems more scientific. However, even this is not without flaws. It often happens that the head of the household goes to a city to work in the unorganised sector on a temporary basis or finds job in some public construction programme whereas other members of his family remain in the village and continue to work in agriculture against payment of wages. Properly speaking, this household should be classified as an agricultural labour household even if it derives a major portion of its income from other occupations in some particular years.

According to the National Labour Commission, a major portion of income of agricultural workers is in the form of wages obtained as a result of working on land. These workers have nothing except their labour to earn livelihood. They are generally unskilled and unorganised. In the Census of India 1961, all those workers were included in the category of agricultural workers who worked on the farms of others and received payment either in money or kind (or both). The 1971 Census excluded those people from agricultural labourers for whom working on the farms of others was a secondary occupation.

This brief analysis is enough to prove that even the experts are not agreed upon the definition of agricultural labour. Accordingly, we must remain content with a working definition. ***All those persons who derive a major part of their income as payment for work performed on the farms of others, can be designated as agricultural workers. For a major part of the year they should work on the land of others on wages.***

Growth in the Number of Agricultural Workers

The class of agricultural workers did not exist in India before the advent of Britishers. Sir Thomas Munroe had stated in 1842 that there was not a single landless labourer in India. Undoubtedly, this was an overstatement. However, it can be safely said that the class of agricultural workers was too small to attract any attention. According to the Census of 1881, landless labourers in that year were 7.5 million. In 1921, agricultural workers were 21 million which was 17.4 per cent of the total rural working population. The number of agricultural workers has continuously increased since then. They were 27.5 million in 1951 and 31.5 million in 1961. According to the Census of 1971, the number of agricultural workers was 47.1 million which was 26.9 per cent of the total workers. According to the Census of 1981, the number of agricultural workers was 55.4 million which was 25.1 per cent of the total labour force. According to the Census of 2001, the number of agricultural workers was 106.8 million which is 26.6 per cent of the total labour force of 402.2 million. This shows that ***every fourth person of the labour force is an agricultural worker in India.*** The figures for different censuses are not comparable because the definition of agricultural worker has been modified from time to time. However, an unmistaken tendency of a continuously increasing number of agricultural workers is clearly discernible.

Characteristics of Agricultural Labour Market

The class of agricultural labourers is the most exploited and oppressed class in rural hierarchy. Before Independence, their position was nothing better than that of serfs. They were required to perform all sorts of *begar* on the master's land and house, work as domestic servants from dawn to dusk and do anything and everything that the zamindars demanded of them. They were victims of social discrimination and economic exploitation. If they failed to tow the lines of the master, they were beaten up and tortured. By advancing small loans to them, the zamindars and landlords often succeeded in trapping these poor people in their net and converted them into virtual slaves. This slavery continued from generation to generation and forced the agricultural workers to lead a wretched existence of deprivation and oppression. The situation has improved in the 60 years of Independence. Though even now the class of agricultural workers is the poorest and resourceless class in rural areas, it is no longer a victim of extreme forms of oppression. But economic exploitation continues. Even now their level of income is very low and highly insufficient to enable them to make both ends meet. Even now their consumption standards are very low. In the absence of alternative sources of employment, they are forced to depend on landlords who consequently dictate terms. The simple law of demand and supply operates.

Since their supply is excessive in relation to the demand for them, they have to settle for extremely low wages. The alternative is worse — unemployment.

1. Marginalisation of agricultural labourers. As stated earlier, the number of agricultural labourers in India in 1951 was 27.5 million and this rose to 106.8 million in 2001. As against this, the workforce in agriculture (cutivators *plus* agricultural labourers) rose from 97.2 million to 234.1 million over the same period. This implies that (*i*) the number of agricultural labourers increased by almost four times over the period 1951 to 2001; and (*ii*) as a proportion of work force in agriculture, agricultural labourers increased from 28 per cent in 1951 to 46 per cent in 2001. These facts indicate the fast pace of ***casualisation*** of workers in agriculture in India. Moreover, the share of agriculture in GDP (gross domestic product) has consistently declined over the years (from 55.1 per cent in 1950-51 to 18.5 per cent in 2006-07, at 1999-2000 prices). The implication is that the gap per worker GDP in agriculture and that in non-agriculture widened markedly over the post-Independence decades. ***"The widening gap, considered in the context of casualisation of workforce in agriculture mentioned above, appears to provide a clear indication of the marginalisation process operating in agriculture."***[2]

2. Low wages in agricultural labour market. Agricultural wages and family incomes of agricultural workers are very low in India. The First Agricultural Labour Enquiry reported that the per capita annual income of agricultural labour families was a meagre Rs. 104 in 1950-51, the average annual income of the household being Rs. 447. The Second Agricultural Labour Enquiry reported a further deterioration in the condition of agricultural workers. Thus per capita annual income declined to Rs. 99.4 in 1956-57 and average annual income of the agricultural labour households to Rs. 437.

With the advent of the green revolution, money wage rates started increasing. However, as prices also increased considerably, the real wage rates did not increase much. From his study on "Agricultural Wages in India" spanning the period 1970-71 to 1984-85, A.V. Jose concluded that "In fact stagnation or decline in real wages during the greater part of our period of analysis appears to have been the characteristic feature in a number of Indian States".[3] Increases in output did lead to increase in real wages in some States but "such spurt in real wages has been of a short duration and there is hardly any State which managed to maintain sustained increase in wages over a period of three decades from the mid- 1960s onwards".

G. Parthasarthy estimated the daily money wages in 1984-85 to lie broadly between Rs. 6 and Rs. 11 (excepting Punjab, Haryana and Kerala where they were higher). As against this, the minimum wage required to maintain a basic minimum standard of living was Rs. 22 per day[4]. As is clear, this was considerably higher than the money wages actually prevailing at that time (even in Punjab, Haryana and Kerala). In a nutshell the living conditions of agricultural labourers are truly pathetic.

In a study on the wage rates of agricultural labour in West Bengal in 1990s, Tushar K. Mahanti noted that while the average daily money wage rate more than doubled in 1998-99 over 1990-91 (from Rs. 21.50 to Rs. 49.96), the average daily real wage rate rose by just 13.80 per cent from Rs. 21.50 in 1990-91 to Rs. 24.48 in 1998-99 — an increase of only two rupees and ninety eight paise in eight years or about thirty seven paise on an average in a year. This is despite the fact that West Bengal had registered a remarkable growth in agricultural production during 1990s (in fact, in eight years between 1990-91 and 1998-99, aggregate foodgrains production in the State increased by over 27.5 per cent from 112.70 lakh tonnes to 143.67 lakh tonnes).[5]

In a survey conducted by National Council of Applied Economic Research (NCAER), it was found that the average total income of landless wage earners was Rs. 11,313 while their per capita income was only Rs. 2,308 in 1994 which was 48 per cent lower than the all India average of Rs. 4,485 in that year.[6]

3. Unfavourable employment and working conditions in labour market. The agricultural labourers have to face the problems of unemployment and underemployment. For a substantial part of the year they have to remain unemployed because there is no work on the farms and alternative sources of employment do not exist. Since they are not organised they cannot fight for minimum wages either. Though bonded labour has been abolished in the country, yet news about the existence of this system in rural India keep pouring in daily from different parts of the country. According to the NSS (32nd round), there are still about 3.5 lakh bonded labourers in the country. Even where this practice has been totally abolished, there is no provision for fixation of hours of work. At the time of sowing and harvesting, the agricultural workers have to work on the farms from dawn to dusk. Since they are employed on a daily basis, there is no question of any leave or other benefits for them.

4. Agricultural labour market discriminates against female labour. Female agricultural workers are generally forced to work harder and are paid less than their male counterparts. Such bias against female workers

exists in most of the dryland areas. At many places, wages paid to female workers are even less than minimum wages.

5. High incidence of child labour in agricultural labour market. Incidence of child labour is high in India and the estimated number varies from 17.5 million to 44 million. It is estimated that one-third of the child workers in Asia are in India. The largest number of child workers are in agriculture. Child employment benefits the employer but adversely affects the poor as a class although it may supplement the income of the household supplying child labour. The poor are made worse-off as employment of children brings down the wage levels.

6. Increase in migrant labour. Green revolution has significantly increased remunerative wage employment opportunities in pockets of assured irrigation areas while employment opportunities nearly stagnated in the vast rainfed semi-arid areas. Therefore, there has been a large flow of migrant labour from the latter to the former areas. The number of inter-State distress rural migrant workers is estimated to be around 10 million. Even in areas of abundant labour supply, employers have started preferring rural migrant workers because of the greater control that can be exercised on such labour without regard to any social responsibility. Because of the increasing use of migrant labour, the 'nature' of relationship between buyers and sellers of labour in green revolution areas is changing—from permanent and personal it is becoming temporary and impersonal.

7. Woes of attached labour. ***The agricultural labour market consists of two types of agricultural labourers in India: (1) attached labourers, and (2) causal labourers.*** The latter are 'free' in the sense that they can refuse to work for a particular landlord or zamindar at the prevailing wage rate. They can, if they so wish, leave the village and go to some other places for work. Attached labourers, on the other hand, have no such freedom. They are attached to a particular landlord or zamindar. Thus they have to work on the field of their master and have to accept whatever wages are offered to them. They have been deprived of their freedom in a number of ways. Social customs, oppression and forcible subjugation, burden of indebtedness, etc. have all contributed to strengthen the chains of their serfdom.

INDUSTRIAL LABOUR MARKET

During the period of planning, a large number of industries have been set up across the length and breadth of the country with the result that the industrial labour market has expanded considerably. In 1981, 24.9 million workers were employed in the secondary sector (manufacturing, processing, servicing etc.) and this number rose to 28.4 million in 1991. However, because of the substantial increase in the total number of workers during the post-Independence period as a result of the increase in population, the share of secondary sector in overall employment has failed to increase much — it was 10 per cent in 1951, 12.9 per cent in 1981 and 12.1 per cent in 1991. ***In 2001, the share of secondary sector in overall employment, however, increased to 17.6 per cent (i.e. more than one-sixth of the total).***

Characteristics of Industrial Labour Market

The main characteristics of the industrial labour market in India are as follows :

1. Migratory character. ***An important feature of the industrial labour market has been its migratory character.*** Because of the pressure of population on land, many people fail to find employment in their villages and are forced to migrate to cities in search of employment. Some of them are absorbed in the industrial sector while some get employment in the tertiary sector. Most of these people retain contact with their villages. In fact, many labourers leave behind their families in villages. As a result, they keep visiting their villages off and on. Thus they do not become a genuine part of the city life. Their migratory character also prevents them for joining any permanent labour union. The majority of the workers do not like to pay their membership subscription to the existing unions or take initiative in the formation of new unions because they do not intend to live in the industrial towns permanently. This has been one of the main factors accounting for unhealthy growth of trade unionism in this country.

Much has been written on the above mentioned *village nexus* of the industrial labour in India and the *instability* in industrial labour market that it gives rise to. For instance, the Royal Commission on labour mentioned in this context that "the driving force in migration comes almost entirely from one end of the channel, that is, the village end. The industrial worker is not prompted by the lure of the city life or by any great ambition. The city, as such, has no attraction for him, and when he leaves the village, he has seldom an ambition beyond that of securing the necessities of life. Few industrial workers would remain in industry if they could secure sufficient food and clothing in the villages; they are pushed, not pulled to the city."[7] Similar

observations were made later by the UNO experts according to whom, the forces motivating the migration of rural labour towards industrial towns are not to be found in the inducement of industrial employment, but in economic pressures exerted by adverse rural conditions. As a result, the industrial labour class retains for a considerable period of time all the characteristics of a floating and unsettled rural proletariat.[8] Thus, there has been a 'lack of stability' in the industrial labour market.

Another important characteristic of migratory labour is that people from all over the country have migrated to different industrial towns and cities with the result that ***the industrial working class in a particular city or town is not a homogeneous class.*** Different constituents of this class speak different languages, observe different customs and rituals, and do not interact much socially. These factors have also come in the way of developing a healthy trade union movement in the country.

2. Increasing stability in recent decades. The above picture presents the traditional character of the industrial labour class in India. With the passage of time, things are changing fast. With the break-up of the joint family system, the village nexus about which we have written above, is growing weaker day by day as many migrant labourers now choose to move to cities alongwith their family units. Moreover, whereas the earlier generations of migrant labourers could not separate themselves from their village roots, their grandchildren and great-grandchildren do not have any such connections with village life. In fact, these new generations of young people are more a part of city life as they have been brought up in cities. Therefore, they have no yearning to go back to villages. On the other hand, they are very much attached to city life. Accordingly, over a period of time, the character of industrial labour in India has changed markedly. ***Industrial labour is now much more stable than before.*** In fact, the National Commission on Labour had noted as far back as 1969: "Over the last twenty years, the trend towards the stabilisation of industrial labour has been further strengthened. A worker today is far more urban in taste and outlook than his predecessor. The idyllic notion of a 'village nexus'... has receded to the background owing to the positive measures undertaken in the interest of industrial labour. Even in the more distant plantations, settled labour is more in evidence now."[9]

3. Organised labour in large industries. The 'stability' in industrial labour market witnessed in recent decades has helped in the emergence of ***'organised labour'. In all large industries in the country, the labour is now well organised into trade unions.*** This has increased its bargaining strength and it is now in a position to fight unitedly for protecting its rights and forcing increases in wages, bonus etc. The government has also enacted a number of legislations to protect the interests of industrial labour. Benefits of most of these legislations are limited to organised labour. ***According to Suresh D. Tendulkar, only about 10 per cent of the total work force (consisting of organised labour, including government services) has benefited from the labour policy of the government.***[10]

4. Unorganised labour in small-scale industries. Small-scale and village industries are a 'hybrid' of units of various types ranging from the age-old household industries to modern mechanised small-scale units. Broadly speaking, we can divide them into the following two categories : (*i*) traditional industries based on traditional skills and techniques, and (*ii*) modern small-scale industries making use of modern technology as well as artians' workshops engaged in activities such as repairing of various implements, machinery, vehicles etc. Labour in most of these industries is unorganised. Therefore, it does not derive any benefit from the various government legislations aimed at promoting labour welfare and social security. Also, being unorganised, it gets much lower wages as compared to the labour employed in large industries. Neither it has the same security of employment as the latter.

5. Shift from household industry to non-household industry. During the period of planning, basic and heavy industries have received high priority under the strategy of planned development. This has induced an important change within the industrial labour market – shift from household industry to non-household industry. For instance, as a proportion of labour force, labour in household industry declined from 6.4 per cent in 1961 to 2.4 per cent in 1991 whereas labour in non-household industry increased from 4.2 percent to 7.8 per cent over the same period.

TERTIARY LABOUR MARKET

Tertiary labour market includes workers employed in the following three sectors : (i) trade and commerce, (2) transport, storage and communication, and (3) other sevices. The sector 'other services' includes banking, non-banking financial intermediaries, insurance, real estate and dwelllings etc., and the government sector (public administration, defence and other government services). It is the experience of all countries that as

economic development proceeds, there is a large scale expansion of activites in all the three sectors of the tertiary labour market. For instance, with the increase in industrial production, trade and commerce are also bound to expand. Therefore, more labour is likely to be employed in this sector. As far as transport, storage and communications are concerned, they have a two-way relationship with industrial growth. Industrial growth gives a boost to these activities and these activities, in turn, provide the necessary infrastructure for the growth of the industiral sector. Accordingly, as economic development proceeds, employment in transport, storage and communications also increases. Banking and insurance activites are also closely related with economic development. In fact, investment in the private sector is crucially dependent on the adequate and timely availability of banking and insurance facilities. Economic development also imposes more responsibilities on the government and leads to an increase in government intervention over a wide range of activites. Therefore, more and more people are employed in the government sector with the passage of time.

Expansion of Tertiary Labour Market

Expansion in the tertiary labour market over the first five decades of planning (1951 to 2001) would be clear from the data presented in Table 44.1.

TABLE 44.1. Expansion of Tertiary Labour Market, 1951 to 2001

(million workers)

Sector	*1951*	*1961*	*1971*	*1981*	*1991*	*2001*
Trade and commerce	7.3	7.6	10.0	14.0	20.2	29.1
	(5.2)	(4.0)	(5.6)	(6.3)	(7.1)	(9.4)
Transport, storage and communication	2.1	3.0	4.4	6.1	8.0	12.5
	(1.5)	(1.6)	(2.4)	(2.8)	(2.8)	(4.0)
Other services	14.6	19.5	15.7	18.9	29.8	36.4
	(10.5)	(10.4)	(8.7)	(8.6)	(10.5)	(11.8)

Note : Figures in parenthesis indicate proportion of total work force.
Source : (*i*) Government of India, *The Gazetter of India,* (New Delhi, 1975) Vol. III, Table I, p. 1086; and (*ii*) Tata Services Ltd., *Statistical Outline of India,* 2006-07 (Mumbai, 2007), Table 31, p. 36.

Total number of workers in all the three sectors of the tertiary labour market increased considerably over the period 1951 to 2001. As far as trade and commerce is concerned, the number of workers increased considerably in the post-reform decade, 1991-2001 from 20.2 million to 29.1 million. In 2001, 9.4 per cent (or almost 10 per cent) of total work force was employed in trade and commerce. As far as 'other services' (banking, insurance, government services etc.) are concerned, almost a constant percentage of labour force (about 10 to 11 per cent) was engaged in this sector over the period 1951 to 2001. However, the absolute number of workers engaged in this sector increased by almost two and a half times over the same period (from 14.6 million in 1951 to 36.4 million in 2001). Most remarkable growth took place in the transport, storage and communications sector of the tertiary labour market. In absolute numbers, the growth was from 2.1 million in 1951 to 12.5 million in 2001. In percentage terms, the increase was from 1.5 per cent to 4.0 per cent over the same period.

Characteristics of Tertiary Labour Market

The main characteristic of tertiary labour market has also been the migratory character of labour for a number of decades. As stated earlier, a large number of people from rural areas descended upon cities and towns in search of employment. Some of these were employed in the industrial sector while some others got work in trade, transportation and allied activities. Therefore such labour possessed all the characterstics of migratory labour. ***A practice common in many areas was that of 'contract labour'.*** Contractors requiring workers in different infrastructural projects used to visit various villages and small town and recruit workers. In many cases, they employed the services of intermediaries and middlemen to recruit workers for them. These intermediaries and middlemen became very powerful over a period of time as the labourers became dependent on them for employment. Various commisions have noted that workers had to bribe the intermediaries for securing employment.

However, as the migratory labour started settling down in towns and cities, there was a 'stability' in the workforce in tertiary labour market alongwith stability in the industrial labour market. What is a point of

concern is the fact that ***a large number of workers of the tertiary labour market are engaged in the informal sector*** (domestic services, helpers in shops and establishments, street vendors etc.) where earnings are low and employment uncertain. Just like agricultural labourers, workers in the informal sector also do not have security of service and social security benefits. Morever, they are also subject to many exploitative practices like agricultural workers. Most of the people serving in the informal sector are also underemployed in the sense that they get work for far less hours than is their potential (or requirement).

NOTES

1. Disguised unemployment is a situation where although all people appear to be working on farms, some are totally redundant in the sense that their removal from farms does not lead to any decline in productivity. For example, let us suppose that on some particular farm, five members of a family collectively produce some quantity of wheat. If now the same quantity of wheat can be produced by three persons without in any way changing the farm technology, we can say that two persons on the farm are redundant and we should treat them as unemployed in disguise.
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6. NCAER, *India : Human Development Report, 1997* (New Delhi, 1999), p. 30.
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8. UN, *The Processes and Problems of Industrialization in Underdeveloped Countries* (1955), p. 22.
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CHAPTER

45 INDUSTRIAL LABOUR

Industrial Disputes
• Magnitude of Industrial Disputes • Causes of Industrial Disputes
Industrial Relations: Policy of the Government
• The Legal Arrangement: Industrial Disputes Act, 1947 • The Voluntary Arrangement: Code of Discipline and Industrial Truce Resolution • Other Measures
Labour Legislation
• Laws Relating to Weaker Sections • Laws Relating to Specific Industries • Laws Relating to Specific Matters • Laws Relating to Trade Unions and Industrial Relations
Social Security in India
Social Security Legislations in India
• Workmen's Compensation Act, 1923 • Maternity Benefit Act, 1961 • Employees' State Insurance Act, 1948 • Employees' Provident Fund and Miscellaneous Provisions Act, 1952 • Employees' Provident Fund Scheme • Employees' Deposit Linked Insurance Scheme, 1976 • The Payment of Gratuity Act, 1972 • Employees' Pension Scheme, 1995
A Critical Review of Social Security Measures in India

Interests of the employers and the workers are often in conflict. Workers thus organise themselves into a trade union with the objective of improving their barganing power and protecting their interests. However, frequent industrial disputes adversely affect industrial activity and, therefore, the government invariably strives for peace. To minimise industrial disputes it enacts various labour legislations. To enhance labour welfare, it also enacts social security legislation. In this chapter we propose to discuss the following issues related to industrial labour in India:

- Magnitude and causes of industrial disputes in India.
- Industrial relations policy of the Government of India.
- Different labour legislations in India.
- Social security legislations and a critical review of social security measures in India.

INDUSTRIAL DISPUTES

The industrial sector frequently faces disputes and struggles on account of the fact that the interests of the employers and the employees are often at variance. While the former are interested in reducing wages and increasing the hours of work, the latter are interested in increasing wages and bettering the conditions of work. Industrial disputes often lead to 'strikes' and 'lock-outs.' Strikes are resorted to by the workers to safeguard their interests, while lock-outs are resorted to by the capitalists to pressurize the workers and compel them to tow their lines. Accordingly, ***both of these activities form a part of industrial disputes*** and lead to struggles disturbing the peace and tranquility of the industrial sector. This affects industrial activity adversely leading to under-fulfilment of targets laid down in the plans. It is on account of this reason that all plan documents in India

have emphasized the necessity of preserving industrial peace. The First Five Year Plan, while recognizing the right of the workers to strike, emphasized that "the stress of the administration as well as the efforts of parties should, however, be on avoidance of disputes and on securing internal settlement."

Magnitude of Industrial Disputes

The progress of industrialization has been accompanied by increases in industrial disputes in India. This is a natural outcome of the conditions prevailing in the country. In addition to the fact that the base of industrial structure has considerable broadened and diversified over the years (opening new fields of industrial activity and thus, by implication, increasing the scope and area of industrial conflicts and confrontations), steep price increases and rising costs of living have compelled the workers to resort to strikes to maintain their real wages at least at constant levels.

The total number of work stoppages in 1951 was 1,071 involving 6.91 lakh workers and resulting in a total loss of 38.2 lakh mandays. The number of work stoppages, workers involved and total mandays lost increased considerably over the planning period. The number of work stoppages rose to the high figure of 2,938 in 1974 with the number of workers involved in the strikes rising to 28.55 lakh and the number of man-days lost to 402.6 lakh. The imposition of the Emergency in 1975 and suppressive measures that followed it, resulted in a steep decline in industrial disputes. However, restoration of normal conditions released the 'pent up' unrest among the workers and the years 1977 and 1978 saw a substantial increase in industrial disputes. In January 1982, the textile workers of Mumbai went on a prolonged general strike which resulted in a substantial loss of mandays. During 1989-90, the total mandays lost due to strikes and lock-outs was 30.77 million. This fell to 23.60 million mandays in 1990-91 but rose to 34.57 million mandays in 1991-92. During the last few years, while the number of strikes has declined steeply, the number of lockouts has decreased at a much lower rate. For instance, while the number of strikes fell from 540 in 1999 to only 227 in 2005, the number of lockouts fell from 387 to 229 over this period. ***Mandays lost on account of strikes declined significantly from 10.62 million in 1999 to just 4.83 million in 2004 but rose to 10.81 million in 2005 while the mandays lost due to lockouts rose markedly from 16.16 million to 27.04 million in 2003 and stood at 18.86 million in 2005.***[1] West Bengal, Tamil Nadu and Gujarat experienced maximum instances of strikes and lockouts during January-September 2006. The industries facing the highest incidence of strikes and lockouts in this period were textiles, financial intermediaries (excluding insurance and pension fund), engineering and chemical industries.

Causes of Industrial Disputes

As noted earlier in this chapter, industrial disputes are natural in the industrial sector since the interests of the employers and the workers are diametrically opposite. While the former aim at maximization of profits, the latter aim at maximization of wages and salaries. Disputes on the issues of wages and allowances, bonus, hours of work, leave, privileges, victimisation of employees, etc. are quite common in all countries. ***The two most important causes of industrial disputes in India have been the issue of 'wages and allowances' and 'personnel and retrenchment'.*** In fact, the issue of 'wages and allowances' alone accounted for about 30 per cent of industrial disputes for a considerable period of planning. In the post-liberalisation decade (1991-2001), 'wages and allowances' accounted for 25 per cent of industrial disputes. Another 17.5 per cent of disputes were due to the issue of 'personnel and retrenchment'.[2] This is a natural outcome of the situation that has prevailed in the country during the period of planning. In addition to the fact that wages of industrial workers are very low in this country, the rising price spiral has made it more and more difficult for them to keep their real wages at a constant level. Naturally the workers were forced to resort to strikes. However, despite all xtheir struggle, the industrial workers did not succeed much in forcing a rise in the level of their real income. For example,while the average per capita annual earnings of factory workers rose from Rs. 12,208 in 1991 to only Rs. 15,784 in 1999, the consumer price index number for industrial workers rose from 212 in 1991 (base 1982 = 100) to 424 in 1999 (*i.e.* double the index number in 1991). This implies that the real wages of industrial workers actually declined over the post-reform decade.[3]

In addition to 'wages and allowances' and 'personnel and retrenchment' another important cause of industrial disputes has been ***the issue of bonus.*** The government has not been following a consistent policy on this issue also. It appointed the Bonus Commission in December 1961 under the chairmanship of M.R. Mehar to study the entire issue of Bonus. Consequent upon the recommendations of this Commission, the government enacted the Payment of Bonus Act in 1965. This Act was to apply to all factories employing 20 or more workers and Bonus was to be payable to an employee earning wages upto Rs. 1,600 per month. Bonus was fixed at 4 per cent of annual earnings or Rs. 40 whichever was higher. The Bonus Review Committee, 1972, with B.K.