Import Substitution" to "Export Promotion" — A Paradigm Shift

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1. Introduction:

The macro economic variables like Gross Domestic Product, National Income data, General Price level and Balance of Payment are the main parameters that form the basis to judge the performance of the economy.
Out of above, "General Price Level" and "Balance of Payment" are matter of real concern for the Indian economy. In fact, due to sustained rise in general price level, the Indian goods have become uncompetitive thereby making terms of trade unfavorable. Even though Exports are rising the percentage rise in Exports is uneven and Imports are rising at a faster rate resulting into deficit in Current Account.
The study undertaken therefore is an attempt to make a critical analysis of the BoP deficit which is really a chronic feature of Indian economy.

In view of this, objectives of the present research paper are as follows:

- To take an overview of trends in Balance of Payment and **to study Current trends in Exports and Imports of India.**
- To make a critical study of paradigm shift in Trade Policies i.e. **Import Substitution to Export Promotion** through incentives and promotional schemes for exporters.
- To analyze various **causes of inconsistent growth in exports and consistent rise in Imports.**
- To explore the possibility of rethinking of **Import curtailment as a supplementary measure to Export Promotion.**

1.2 The organization of research paper is as follows:

Part I : In this part initially the conceptual framework of Balance of Payment and literature reviewed is covered. In the later part emphasis is laid on the secondary data obtained from various publications of RBI and DGIC reports etc. and analysis thereof.

Part II : In this part, an attempt has been made to explore the possibility of offering some policy suggestions based on economic principles with an aim to improve the Balance of Payment.
The "Limitations of the study and Scope for further Research" has also been covered in the research framework.

2. Part-I
Conceptual framework of Balance of Payment:

2.1 According to Ellsworth, "Balance of Payment is a systematic record of all economic transactions that take place between residents of the reporting country and residents of some other countries." The balance of Payment is conventionally classified into Current Account and Capital Account. The Current Account covers transactions pertaining to movement of merchandise i.e. Exports and imports and also Export and Import of services along with Investment income receipts and payments and unilateral transfers. The Current Account is treated as synonymous to the Trade Account. The Capital Account relates to changes in financial assets and liabilities. The "Basic Balance" comprises of Current Account and long term capital to which Net effect of short term capital transactions is given to arrive at overall balance which is also known as "Reserve Transaction Balance".

As a general working rule, credit items in the Balance of Payment reflects transactions that give rise to payment inward to the home country. The major items are Exports, Foreign investment inflows and receipts of interest and dividends by the home country from earlier investments abroad.

The debit items in the Balance of Payment reflect transactions that give rise to payment outwards from the home country. The major items are Imports, Investments made by domestic nationals in foreign country and payments of interest and dividends by the home country on earlier investments made in it by foreign investors.

2.2 The Current Account in the Balance of Payment is important because it essentially reflects sources and uses of National Income. Another way to view Current Account balance is to relate it to the Aggregate Income and Expenditure. The macro economic identity is---

Y= C+I+G+(X-M)

Where Y= Aggregate Income, C= Consumption spending, G= Governments' spending,

X= Exports and M=Imports.

Therefore, we can rearrange above equation as follows:

Y- (C+I+G) = X-M.

In the above, Y can be written as C+S+T i.e. Income can be used for the purpose of Consumption, Investment and Taxes.

C+I+G+(X-M) = C+S+T

Therefore X-M = S+ (T-G)-I where S+ (T-G) is total saving and I stands for Investment. Therefore Current Account balance is equal to difference between saving and Investment. From above, we can say that when Current Account is in deficit, it means savings are less than Investments and vice versa.

3. Review of literature:

The researcher has carried out an extensive review of literature comprising of following:

i. Articles on Current Account Deficit appeared in "Economic Times", "The Financial Express" and Reports published by RBI from time to time. (Refer bibliography)

ii. The relevant texts on Balance of Payment from readings in International Economics. (Refer bibliography)

The literature reviewed above, brought to light important facts as regards causes of the Current Account deficit and same are highlighted below:

3.1 India's **Current Account deficit has trebled** to a worrying $ 13.7 billion in the three months to June 2010 from $ 4.5 billion in the year earlier. The Finance Minister has expressed concern over this rising Current Account deficit.

Exports grew by 22.5% but Imports grew faster at 32.3%.

3.2 The following are the major reasons for widening Current account deficit:

I. Cheap money is sloshing around the globe is finding its way to Developing nations including India, pushing up local currency value. This leads to higher Imports. Rising Imports is an indication of strong demand.

II. There is consumer reluctance in the West to spend because of rising unemployment. So exports are stagnating.

III. Foreign funds flows are expected to be all time high $ 25 Billion pushing up stock prices, rupee is appreciating which is hurting exports earning and may shake the economy when overseas investors pull their money out.

IV. Rise in oil prices has increased the value of Imports. Oil balance (Imports – Exports) deteriorated to -5.4% in 2008-09 from -4.3% of GDP in 2007-08.

V. Services Exports fell due to slowdown in non- software services. It has decreased to 0.9% in 2009-10 from 1.4% of GDP in 2008-09.

VI. Government's aggressive push for higher domestic demand at a time when trend in exports has yet to be recovered fully. Low real interest rates and loose fiscal policy have pushed up domestic demand at a time when capacity creation was impacted by global credit crisis.

VII. Government's loose Fiscal Policy has pushed saving rate down and increased Saving Investment gap.

VIII. Sectors like Readymade garments, handlooms, handicrafts and carpets continuing to perform badly in Export market.

3.3 In the process of reviewing the literature, the researcher also came across articles published in various RBI journals and reports on the circumstances that led to shift in the policy from "Import Substitution" to "Export Promotion" along with ways and methods of "Import Substitution" and economic rationale for the shift. The relevant details thereof are highlighted below:

I. The Import substitution can be done by following ways:

iii) **Tariff** is levied on imports of specific goods.

iv) **Payment of Export subsidies:** When the government offers an export subsidy, shippers will export the goods up to the point where the domestic price exceeds the foreign price by the amount of the subsidy.

v) An **import quota** is a direct restriction on the quantity of some good that may be imported. The restriction is usually enforced by issuing licenses to some group of individuals or firms.

vi) **Export credit subsidies:** It takes the form of a subsidized loan to the buyer. The government institution provides subsidized loans to aid exports.

II . The most important economic argument for import substitution is the "Infant industry argument". According to which, industries always needs to be sheltered when they are in an infant stage. The Developing countries have a potential comparative advantage in manufacturing but such Infant industries in developing countries cannot initially compete with well established manufacturing industries in developed countries. Thus, government should temporarily support new industries. It is evident from the data, which shows that manufacturing sector has made a sizable contribution in Indian Exports. In the late 1980s a new conventional strategy stressed the virtues of free trade. Thus, the countries adopted trade liberalization as an 'Outward looking' policies instead of Import substitution as an Inward looking policy. In the early 90s, India adopted an import substitution policy since its independence. Since 1990, India has introduced wide ranging economic policy reforms and is moving towards market driven economies. This has resulted in consistent high economic growth over the last one and half decades, thereby making India the tenth largest economy in the world. At present India is the second fastest growing economy in the world. After 1990s, the focus of trade policy reforms in India has been on liberalization, openness and globalization with a basic thrust on outward oriented export promotion activity. To achieve this objective, there is removal of quantitative restrictions and improving competitiveness of the Indian industry to meet global market requirements.

III. Export promotion measures:

In conformity to the policy of "Import Substitution" to the "Export Promotion", various incentives have been given to the exporters.

The features are highlighted below:

The Foreign Trade Policy (2009-2014) of India has come out with various set of Export Promotional measures that will catalyze the growth of Exports.

The FTP had set two objectives:

(i) To double our percentage share of global merchandise trade within five years.

(ii) To use trade expansion as an effective instrument of economic growth and employment generation.

The short term objective is **to arrest and reverse the declining trend of Exports** and to provide additional support especially to those sectors which have been hit badly by recession in the Developed world.

To achieve this target, the Government would take support of three pillars.

- **Incentives** that will enhance market access across the world, technological up gradation.
- **Improvement in infrastructure** related to exports.
- Providing **full refund of all indirect taxes and levies.**

To sum up the literature reviewed so far brought to light various causes of Current Account deficit(X-M) and remedy that has been suggested is in the form of "Export Promotional Measures" initiated from time to time in line with paradigm shift in policy of "Import Substitution to Export Promotion". **It is observed that the literature reviewed so far mainly focuses on X component i.e. Export, while M component has taken a backseat particularly after shift in the policy from Import Substitution to Export Promotion.**
Hence, it is felt necessary to probe further to find out reasons for the persistence in Current account deficit in spite of such promotional measures covered in the literature reviewed. The novelty of the proposed Research Paper precisely lies in going into the root causes of the persistent deficit by focusing on Import component (M) of the BoP and stresses the need to have a relook into the policy of Import substitution and Export promotion for more effective results.
Against this background, the very purpose of the research and theme of the research revolves around analyzing of trends in Imports/ Exports initially and relooking into the policy of import curtailment and export enhancement later, as envisaged in the objectives stated above.
The further part of the research goes towards fulfillment of the objectives stated and exploring the remedial measures to cure deficit as implied in the organizational framework above.

4. An Overview of Balance of Payment position of India:

4.1 The researcher has studied the BoP position after liberalization i.e. after 1991. In terms of absolute figures, even though exports show rising trend still the rise is at decreasing rate. All this culminate into deficit in the Balance of Payment and it has become a chronic feature of Indian economy as is evident from the BoP data reproduced belo

Table 6.2 : Balance of Payments : Summary#

(in US $ million)

	1990-91	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	(April-Sept.) 2004-05	(April-Sept.) 2005-06
1. Exports	18477	34298	37542	45452	44703	53774	66285	82150	36715	44761
2. Imports	27915	47544	55383	57912	56277	64464	80003	118779	51483	76396
Of which : POL	6028	6399	12611	15650	14000	17640	20569	29844	14578	20834
3. Trade balance	-9438	-13246	-17841	-12460	-11574	-10690	-13718	-36629	-14768	-31635
4. Invisibles (net)	-242	9208	13143	9794	14974	17035	27801	31229	14283	18679
Non-factor services	980	2165	4064	1692	3324	3643	10144	14199	5980	9512
Income	-3752	-3544	-3559	-5004	-4206	-3446	-4505	-3814	-1917	-3078
Pvt. transfers	2069	10280	12256	12854	15398	16387	21608	20253	9968	12043
Official transfers	461	307	382	252	458	451	554	591	252	202
5. Current Account Balance	-9680	-4038	-4698	-2666	3400	6345	14083	-5400	-485	-12956
6. External assistance (net)	2204	799	891	410	1117	-3128	-2858	1923	346	436
7. Commercial borrowing (net)@	2254	4367	333	4303	-1585	-1692	-2925	5040	1526	2752
8. IMF (net)	1214	-393	-260	-26	0	0	0	0	0	0
9. NR deposits (net)	1536	961	1540	2316	2754	2978	3642	-964	-1334	174
10. Rupee debt service	-1192	-802	-711	-617	-519	-474	-376	-417	-279	-142
11. Foreign investment (net)	101	2312	5117	5862	6686	4161	13744	12147	2490	7411
of which :										
(i) FDI (net)	96	2380	2093	3272	4734	3217	2388	3240	1979	2304
(ii) FIIs	0	-390	2135	1847	1505	377	10918	8280	339	4227
(iii) Euro equities & others	5	322	889	743	447	567	438	627	172	880
12. Other flows (net)+	2284	623	3930	-3739	-96	8795	6111	13830	4672	8827
13. Capital account total (net)	8401	7867	10840	8509	8357	10640	17338	31559	7421	19458
14. Reserve use (- increase)	1279	-3829	-6142	-5842	-11757	-16985	-31421	-26159	-6936	-6502

\# Actuals.
@ Figures include receipts on account of India Development Bonds in 1991-92, Resurgent India Bonds in 1998-99 and India Millennium Deposits in 2000-01 and related repayments, if any, in the subsequent years.
\+ Include, among others, delayed export receipts and errors & omissions.
Source : Reserve Bank of India.

4.2 From the above data it is observed that:

i) Barring few years, i.e. from 2001 to 2004, Current Account deficit continues.

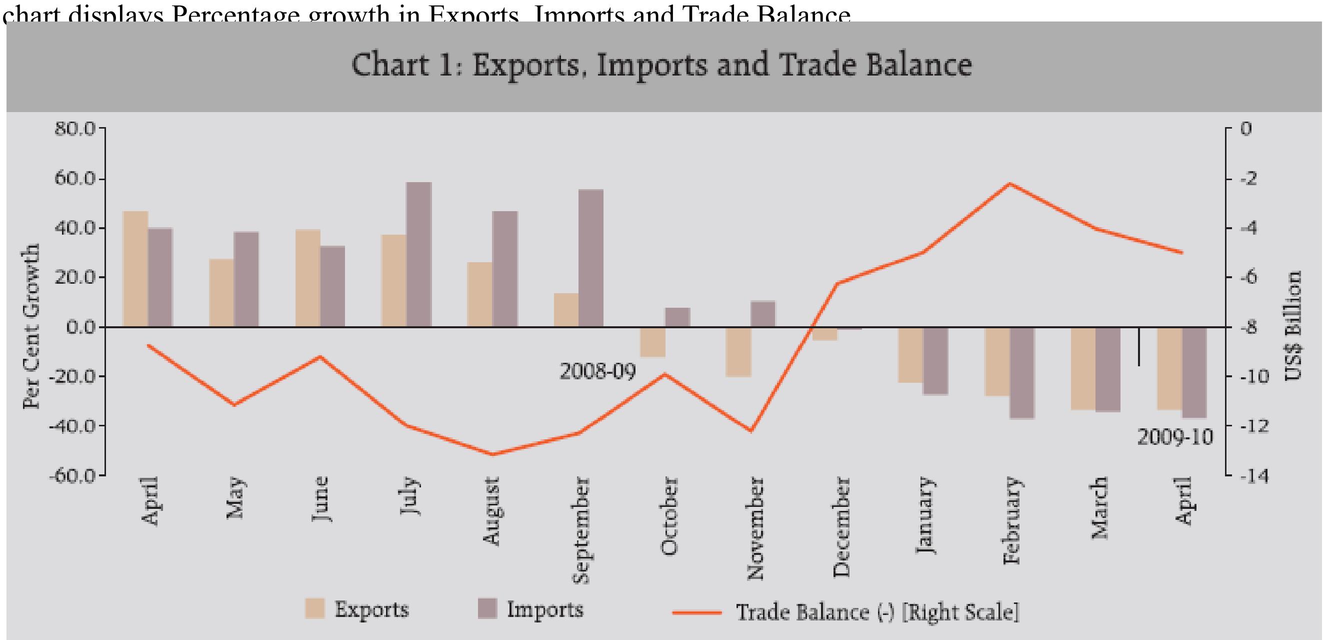
ii) Though there has been growth in exports, there has also been corresponding rise in imports too resulting chronic deficit as a feature of Indian economy.

iii) Current Account deficit is not fully financed by Capital account and necessitates drawing down on reserves.

The observations made above and analysis of the data led researcher to probe further into the causes of chronic deficit against the background of Export Promotion measures announced by the Government from time to time. **It is pointed out that there has been uneven growth of exports and even percentage rise is at decreasing rate. Hence, it is follows that either export promotion measures appears to be inadequate or the benefits accrued in the form of earning foreign exchange are offset by corresponding rise in imports.**

5. Current Trends in Exports and Imports:

5.1 The subprime crisis in the US housing mortgage market in 2007 has disturbed general equilibrium and has emerged as a global financial crisis, leading to global economic recession thereby affecting external sector of many developing economies including India. The crisis has impacted India's foreign trade in a great magnitude. In order to make trend analysis more meaningful, the researcher thought it fit to consider the period of two years 2008-09 and 2009-10 and has studied the impact on Exports, Imports and Current Account deficit. The following chart displays Percentage growth in Exports, Imports and Trade Balance.



Source: RBI Report.

5.2 From the above chart, it is observed that:

i. The percentage rise in Imports more than offsets percentage rise in exports (barring April 2008.)

ii. The Trade Account continues to be in deficit.

6. Analysis of causes of uneven export growth:

The uneven Export growth is attributed to specific factors like:

(a) Due to globalisation, the international market has become increasingly competitive and exporters are unable to sell the products at internationally competitive prices.

(b) The exporters are not well conversant with the various promotional schemes launched by Government authorities.

(c) The fluctuations in exchange rates have an adverse impact on Indian exports. This was particularly observed when appreciation of rupee occurred in the year 2006-07.

(d) Other factors like social aspects, marketing of Indian products, and lack of entrepreneurship skills play an important role towards taking up export activity.

(e) Cost of availing finance plays a crucial role in initiating export activity and setting the competitive price of the products.

(f) Indian exporters are not well conversant with International hygiene standards resulting exports of agriculture goods has suffered considerably and there have been several instances of consignments being rejected. Recently, (May 2010) the consignments of grape exporters were rejected by the European authorities due to the presence of chlormacvat, a chemical residues.

7. Analysis of causes of growth in Imports:

(a) In Developing economies including India**,** local currency values are pushing up. This leads to higher imports.

(b) There is strong demand in the country which leads to rising Imports.

(c) There is continuous rise in oil prices which increases the value of Imports.

(d) Government's aggressive push for higher domestic demand, low real interest rates and loose fiscal policy have pushed up domestic demand which leads to rise in Imports.

8. To explore the possibility of Import curtailment as a supplementary measure to Export Promotion.

8.1 The literature reviewed on "Import Substitution" discussed the circumstances that led to shift in the external Trade Policy. Apart from Infant Industry Argument the economic reasoning put forward for shift in policy was to be in line with changing economic scenario i.e. globalization and accordingly the relaxation was made in removing exchange controls on Import and Export and Outward/Inward remittances. The relaxation in Imports was further justified in view of relatively comfortable foreign currency reserve position. The relaxation in imports were mainly in the form of removal of License Raj and increasing the list of commodities to be included in the Open General License. Apart from this, relaxations are also being made on Capital Account and Indian rupee is almost convertible on Current Account. As a part of liberalization measures, various incentives are given in the current Foreign Trade Policy to the exporters. However, the researcher felt that in spite of all these promotional measures (particularly given to the existing as well as prospective exporters) the results are not up to the desired level and same is evidenced from the interpretation of data on BoP that clearly indicates that though liberalization has helped in promoting exports, the Exports are rising at decreasing rates and Imports are continuously rising thereby offsetting benefits of Exports. The resultant effect is irrespective of policy measures, the BoP continues to be in red. Hence, the researcher felt it necessary to have a relook into the policy of Import Substitution and Export Promotion.

As stated above since the growth of Exports is at decreasing rate the researcher has focused on Import component of the BoP. Therefore in the further part, the researcher has analyzed the composition of Imports by applying the **technique of elasticity** so as to identify demand elasticity of Imported commodities with the help of **"Total Outlay Method"** discussed in traditional economic literature.

In order to calculate the total outlay so as to identify and list out the commodities with different elasticity of demand, the following methodology has been adopted:

i) The collection of data of principal commodities imported is taken for the period from 2006 to 2009. (Refer table 8.2)

ii) The selection of commodities is based on its composition in the total Imports of India. (Refer table 8.2)

iii) The total expenditure with respect to commodities selected has been worked out for the period under consideration and is compared with corresponding change in price to determine elasticity. (Refer table 8.3)

8.2 Composition of Indian Imports

India's Imports of Principal Commodities				
Commodity	2006-07	2007-08	2007-08	2008-09
1. Petroleum, crude and	30.8	31.7	32.6	32.8
Products				
2. Capital goods	25.3	28.2	24.4	22
3. Gold and silver	7.9	7.1	7.6	6.8
4. Organic and inorganic				
Chemicals	4.2	3.9	4.2	4.3
5. Coal, coke and				
briquettes, etc.	2.5	2.6	2.7	3.6
6. Fertilisers	1.7	2.2	2.4	5.1
7. Metalliferrous ores,				
metal scrap, etc.	4.5	3.1	3.3	2.9
8. Iron and steel	3.5	3.5	3.7	3.3
9. Pearls, precious and semiprecious				
Stones	4	3.2	3.4	4.9
10. Others	19.6	18.7	20.1	19.6
Total Imports	100	100	100	100

Source: DGCI&S.

8.3 Total outlay of Indian Imports

		APRIL 2008 TO JAN 2009			APRIL 2009 TO JAN 2010		
COMMODITIES	UNIT	QUANTITY	VALUE	PRICE	QUANTITY	VALUE	PRICE
PETROLEUM, CRUDE & PRODUCTS	TON	130560115	37952161	0.2907	146824491	33347590	0.2271
COAL,COKE & BRIQUITTES ETC.	TON	49901695	3983133	0.0798	61014387	3456889	0.0567
TEA	KGS	22307710	17160	0.0008	28514524	23403	0.0008
IRON & STEEL	TON	5926595	3635877	0.6135	7272247	3020574	0.4154
CEMENT	TON	811123	29542	0.0364	1844111	48609	0.0264
FERTILEZERS MANUFACTURED	TON	15289181	5204761	0.3404	13829790	2491256	0.1801
GOLD			8848177			10401312	
SILVER			939080			282701	
SUGAR	TON	117381	19156	0.1632	1810192	388124	0.2144
FERTILIZERS,CRUDE	TON	4186382	419022	0.1001	4105010	246591	0.0601

Observations:

i) It is observed that:

a) POL products have inelastic demand as total outlay (Value) has increased with increase in price so is the case with Iron & Steel and sugar as well as fertilizer.

b) In respect of cement, with the fall in the price, there has been sharp rise in expenditure and therefore demand is highly elastic.

9. Conclusions:

In the research undertaken, the attempt has been made to make a critical study of the BoP position and it is observed that BoP continues to be in red. The researcher has probed deeper to know the causes for chronic deficit in spite of export promotional measures taken up by policy makers in conformity to paradigm shift from Import substitution to Export promotion since the Globalization.

The further study brought to light an important fact that the favorable impact of Exports is wiped out by corresponding increase in Imports resulting into sustained deficit in BoP. The study also revealed that while pursuing the policy of Import Substitution to Export Promotion, the Imports have taken a backseat and the need of hour is to focus on import component rather than Export. Therefore the researcher collected the data for the current period and made a scientific analysis of the data with the help of economic principles of "Demand Elasticity". It was observed that in respect of POL products, Iron & Steel etc. the Demand elasticity is low while it is high in respect of commodities like Cement which led researcher to suggest that for commodities having high elasticity, Tariff and Quota measures should be applied, while those commodities having low elasticity of demand the researcher proposes extensive innovative methods to develop substitute products in the Home Country e.g. POL items having highest component to the tune of 30% almost, an innovation of substitute source of fuel energy coupled with stringent restriction on its availability would go long way in saving the valuable foreign exchange that can be utilized for the import of goods having inelastic demand. It is also felt that like incentives to the exporters, the policy should be in giving high subsidy to industries promoting such innovative products.

Thus, the critical analysis of the India's Balance of Payment led us to the fact that apart from Export Promotion, the Import Innovation is a real challenge ahead. Hence, to conclude, the punch line to be promoted by Policy Makers should be **"Import Replacement through Innovation coupled with Export Promotion."**

10. Scope for Further Research:

a) The centre theme of the present research work revolves around the "Elasticity of demand" for the components of imports without probing into the reasons why elasticity is low or high for particular commodity. Thus, there is a sufficient scope to investigate further in finding out causes of low or high elasticity and suggest suitable measures so as to reduce the component of inelastic goods in composition of imports.
b) The whole research focuses on import products assuming enough has been done for exports but analysis of supply elasticity of exports would shed more light on improving BoP position.

11. Limitations of study:

a) The fluctuations in exchange rate, general price level and its impact on elasticity is not considered.
b) The whole research has been carried out by considering Current Account of the Bop and impact of capital flows on the domestic currency which in turn affects the BoP is beyond the scope of study.

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