From Protectionism to Global Integration: India's Trade Policy Before and After 1991

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The outline of the 1991 story, India's big liberalization adventure, is well known to most India observers: the balance-of-payments crisis, the clandestine transportation of gold in chartered carriers,[1] the International Monetary Fund loan, rupee devaluation, reforms. These few key words evoke memories of that story. The story of the reforms has been told many times in the academic literature and the popular media and will be covered extensively in other essays in this series.

The Indian economy until 1991 was characterized by industrial licensing and the infamous Monopolies and Restrictive Trade Practices Act,[2] import substitution and severe trade restrictions, a large public sector, a bloated and powerful bureaucracy in charge of steering economic activity, and a large welfare state with unsustainable public expenditure. The result of these policy measures was low to middling growth, high poverty and inequality, a stifled private sector, dwindling exports, high unemployment and underemployment, and a lack of consumer choice and welfare, among other effects. A 15-year waiting period for a Bajaj scooter and a 10-year waiting period for a fixed telephone line connection epitomizes the state of the Indian economy and the quality of life of the average citizen during this period.

This essay will focus on India's import policy—the highly restrictive and protectionist tendencies until 1991, the liberalizing reforms, and the effects of the reforms on the Indian economy. Post independence, the Indian government disfavored free trade and imposed heavy restrictions on imports using tariff and nontariff barriers while trying to encourage exports using

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[1] C. Rangarajan's retelling of this story is fascinating. See Rangarajan, "1991's Golden Transaction," *Indian Express*, March 28, 2016.

[2] The Monopolies and Restrictive Trade Practices Act was enacted to guard against the concentration of market power and the growth of monopolies. However, it led to extremely strict licensing controls and stifled industrial activity by disallowing firms to grow.

subsidies. The large theme of India's trade policy during this period was that each instance of trade liberalization and reform was not only backtracked soon after it came into effect but also pulled further back—a case of one step forward and two steps back. For instance, small reductions in import duties was followed by bigger hikes, or any easing of license requirements was followed by stricter requirements in the next period. This was followed by piecemeal and inadequate liberalization in the 1980s.

The year 1991 witnessed a balance-of-payments crisis. The government responded with currency devaluation, relaxation of the import licensing system, and a broad reduction in tariffs. In the years following the reforms, the Indian economy grew at significantly higher rates, the share of trade in India's GDP increased, and the share of Indian goods and services in global trade increased.

India's Trade Policy in the Context of Global Trade

While India embarked on a highly protectionist trade policy in the 1950s and thereafter, global trade in the same period had largely gone in the opposite direction. After the Second World War, along with efforts to establish peace and security in the global order, the United States and Europe were making efforts to establish a new global economic system that could facilitate greater economic integration among countries. The Bretton Woods Conference saw the establishment of the International Monetary Fund and the World Bank, intended to oversee exchange rate stability and postwar reconstruction, respectively.

Along with the establishment of the twin institutions at the Bretton Woods, two other important events led to lower trade barriers and greater trade volume in postwar Europe and United States—the signing of the General Agreement on Tariffs and Trade and the Marshall Plan, respectively. In 1947, 23 countries signed the General Agreement on Tariffs and Trade, which was established to promote international trade by a reduction of trade barriers, such as tariffs and quotas. This was done partly to avoid the mistakes of the 1930s, when waves of protectionism across the world had resulted in beggar-thy-neighbor policies and had helped extend and intensify the Great Depression. Average tariff rates in the industrialized nations were close to 40% in 1947, but they gradually declined after the agreement came into effect, to about 15% in the 1970s. Just the Geneva round of negotiations in 1947 witnessed the 23 countries making at

least 123 agreements covering 45,000 tariff items, which covered nearly half of overall world trade.[3]

The European Recovery Program (commonly referred to as the Marshall Plan), enacted in 1948 by the US government, contributed to rapid economic growth in Europe in the 1950s and consequently led to greater trade and economic integration.

A combination of these factors resulted in rapid expansion in world trade. This expansion was long-lasting: world merchandise exports rose by more than 8% per annum in real terms over the 1950–1973 period. Trade volumes also increased in value, from $78 billion in 1953 to $567 billion in 1973 (albeit in nominal terms).[4] Trade volumes took a hit in the mid to late 1970s because of oil price shocks and the subsequent stagflation in the United States, but they recovered in the 1990s with the establishment of the World Trade Organization after the Uruguay Round of trade negotiations in 1994.

The mood and approach toward trade was quite different in the USSR bloc and in many developing countries. The Soviet Union and other communist countries took a deliberately autarkic approach to trade, and many recently independent developing countries were also wary of free trade and its possible impact on their fragile economies. Thus, many developing countries in Latin America, Africa, East Asia, and the Indian subcontinent embraced import substitution industrialization policies, though during differing time periods. However, the economic outcomes in the countries that adopted these policies were nearly universally terrible. By the 1980s most countries had abandoned such policies in favor of freer international trade.

Postindependence, India pursued socialist-minded development policies that emphasized self-reliance and state-led investment in heavy and capital-intensive industries. The next section will look at the evolution of India's trade policies from the 1950s until the 1991 reforms.

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[3] Douglas A. Irwin, "The GATT's Contribution to Economic Recovery in Post-war Western Europe" (International Finance Discussion Papers, Federal Reserve Bank, 1993).

[4] Lynden Briscoe, "The Growth and Structure of International Trade since the Second World War," *British Journal of International Studies* 1, no. 3 (1975): 209.

India Takes the Route of Near Autarky Postindependence

Indian trade policy has a long and complicated history. Protectionist tendencies reared their heads as early as 1921, when local industries demanded and were granted tariffs on imported goods to protect them from international competition. Meanwhile, the concept of Swadeshi (import substitution) was popular as an economic tool against the British. India's trade policy postindependence is not unidirectional—there were some twists and turns on the way, as each attempt at liberalization rebounded to a more restrictive regime.

This history can be sliced in different ways, punctuated by changes in either direction or intensity. Arvind Panagariya uses a simple three-period approach: virtual autarky (1950–1975), ad hoc liberalization (1976–1991), and deeper and systematic liberalization (1991–present).[5]

Just before independence, the British government in India imposed severe restrictions on trade. One of the relics of this regime was the system of Open General License (OGL). Since foreign exchange was hard to come by, it required rationing, and only essential items—which were put on the OGL list—were permitted for importing. This system remained in place well after the British left Indian shores.

Even after independence, the OGL system worked as a positive list—only those items that were on the list could be imported without a license, subject of course to other bureaucratic requirements. Importing any item not on the list required a license from the Ministry of Commerce. Therefore, the curation of this OGL list was a task of great import (excuse the pun), but without any accountability. Additions to or deletions from the list did not require parliamentary debates or approval; they were subject only to bureaucratic wisdom.

In the early 1950s, there was a slight inclination toward liberalizing some of the import controls, mainly because of a buildup of foreign exchange reserves due to the war. At an aggregate level, the First Five-Year Plan made an attempt at progressive liberalization by allowing for some imports and expanding the scope of the OGL list.

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[5] Arvind Panagariya, "India's Trade Reform: Progress, Impact and Future Strategy," March 4, 2004, http://www.columbia.edu/~ap2231/indias-trade-reform-progress-impact-and-future-strategy.

The relatively weak attempt at liberalization in the early 1950s was quickly reversed following a foreign exchange crisis in 1956. Strict implementation of the import licensing system in tandem with overall tighter controls over all forms of economic activity ensued. This period witnessed high levels of distortion in the domestic markets and international trade as they were subject to increasingly discretionary policies. The knee-jerk reaction to the crisis was to arbitrarily control and limit imports to match the available foreign exchange. The OGL list was pruned, and many items were outside the list again.

For the next couple of decades, import policy was driven by the government's need to have complete and direct control of foreign exchange utilization. Foreign exchange was allocated by the administration for practically all uses in the economy. Jagdish Bhagwati and T. N. Srinivasan provide an excellent account of how this would play out:

> For each six-month period, the Ministry of Finance prepared an estimate of the available foreign exchange. In the first stage, debt repayment, Embassy expenditures, food, fertilizer, petroleum, oil and lubricant (POL) and defense needs were netted out from the estimated reserves. At the next stage, allocations were made to (1) different public-sector undertakings for their raw material and machinery imports, (2) Iron and Steel Controller and (3) Commerce Ministry for private sector imports of raw materials and machinery. A large multiplicity of licensing agencies was involved in the allocation process before foreign exchange reached the actual user. Typically, imports of raw materials were not permitted if domestic substitutes were available.[6]

Under this new regime, where the allocation of scarce foreign exchange became the primary target of trade policy, a producer could easily block any imports and gain protection. Imports of products that had indigenous substitutes were not granted foreign exchange; thus, if a producer wanted to block the import of any commodity, it could let a relevant authority know that it had

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[6] Jagdish N. Bhagwati and T. N. Srinivasan, *Foreign Trade Regimes and Economic Development: India* (New York: National Bureau of Economic Research, 1975).

made an indigenous substitute. The quality, price, and delivery date were not relevant to the decision.[7]

The 1966 Devaluation

Back to the timeline: sustained fiscal profligacy and the issuance of ad hoc Treasury bills to the Reserve Bank of India led to an increase in money supply in India during the 1960s. This resulted in higher inflation and a currency that was severely overvalued in real and nominal terms. The exchange rate, however, was fixed (pegged to the pound sterling), and—because India had higher domestic prices relative to the world—Indian goods become uncompetitive in the world market (decreasing exports) and foreign goods became cheaper (increasing imports). This took a toll on the foreign exchange reserves of the country.

A couple of other geopolitical reasons, including the cutoff of foreign aid (which had been helping with the foreign exchange reserves until then) following the 1965 war with Pakistan, necessitated a devaluation of the rupee. The devaluation meant that the effective value of the rupee went from 4.76 per dollar to 7.50 per dollar. That worked out to be a devaluation of 57% in nominal terms.[8] In real terms, it worked out to be a 30% devaluation.

The 1966 devaluation was accompanied by some reforms—tariff reductions, small relaxations in the import licensing requirements, and a general reduction (and in some cases abolition) of export subsidies.

However, both the devaluation and the first steps toward liberalization proved to be immensely unpopular domestically. Further, the government was not too keen on giving up the ability to hand out export subsidies and special favors. Finally, the diplomatic isolation of Indira Gandhi by the United States (around the time of the Bangladesh war in 1971) led to a complete reversal of the liberalization measures. A regime of tight import controls was reinstated, which saw an effective ban on the import of nearly all consumer goods (including textiles). Only intermediate

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[7] Panagariya, "India's Trade Reform."

[8] Ira Dugal, "Why 6/6/'66 Was a Devilish Day for the Rupee," *Mint*, June 6, 2016.

materials, components, and capital equipment were allowed to be imported, and only if they were "essential" and not "indigenously available."[9] Panagariya captures the extent of India's turn toward autarky when he notes that "by the mid-1970s India's trade regime had become so repressive that the share of nonoil, non-cereals imports in GDP fell from an already low 7 percent in 1957–58 to 3 percent in 1975–76."[10]

Tariffs

Though tariffs were not the predominant tool of trade policy, they nonetheless played a part in distorting international trade. The Indian tariff structure consisted of three levels:

1) Basic customs duty applied as a percentage of the price of the imported good, which includes manufacturing cost, insurance, and freight charges. This can range from 0%–300%.

2) An auxiliary duty on the price of the good, ranging from 0%–45%.

3) Additional or countervailing duties applied to the price of the good plus the basic customs duty and auxiliary duty. The additional duty was an instrument to bring parity between tax imposed on domestic goods and international goods, so the amount was equivalent to excise taxes imposed on locally produced products.[11]

[9] Garry Pursell, Nalin Kishor, and Kanupriya Gupta, "Manufacturing Protection in India since Independence" (paper presented at "The Indian Economy at 60: Performance and Prospects; A Conference to Mark 60 Years of Indian Independence," Australia South Asia Research Centre, Australian National University, 2007).

[10] Panagariya, "India's Trade Reform."

[11] Garry Pursell, "Trade Policies in India," in *National Trade Policies*, ed. Dominick Salvatore (New York: Greenwood, 1992).

The first issue with this system is the cascading taxes, where a tax is applied at successive stages without any deduction for the taxes paid at earlier stages. So additional or countervailing duties are applied on top of the basic customs duty plus the auxiliary duty.[12]

The second issue regards exemptions at the different levels of taxation. A certain good might attract the basic duty plus an additional duty but be exempted from the auxiliary duty—or any other such combination. The result was that an importer could never be sure in advance of the exact amount of taxation that the product would attract.

Overall, the general level of duties in India was much higher than in most other developing countries at that time. Further, the relaxation of import licensing requirements for some goods in the 1980s was accompanied by an increase in tariffs. Tariff revenue as a proportion of imports rose from 20% in 1980/81 to 44% in 1989/90. In 1990/91 the highest tariff rate stood at 355%, the simple average of all tariff rates at 113%, and the import-weighted average of tariff rates at 87%.[13]

Nontariff Protection and the Import Licensing System

Under the import licensing system until 1991, tariffs lost most of their relevance as a tool of trade policy. The government raised tariffs several times and they were substantially higher than global standards, but they functioned primarily as a revenue-raising tool. Import behavior was influenced through licensing rather than tariffs. Exports were continuously encouraged via subsidies, at high costs to the exchequer.

[12] To illustrate the effect of cascading taxes, imagine that a TV was being imported into India. It costs 10,000 on entering India's shores. But TV is considered a luxury, so it would attract a pretty high tariff, say 250%, which brings the cost to 35,000. Then, an auxillary duty of 30% applied on the original cost of 10,000 would add 3000 to the total, bringing it to 38,000. Further, an additional duty of say 10% would be applied on the original price plus the other taxes, instead of just on the original price. This tax on tax is referred to as cascading taxes. The final cost of the TV would be 41,800.

[13] Panagariya, "India's Trade Reform."

Nontariff controls were the predominant means of protectionism. These controls included the import licensing system, canalization, the "actual user" policy, phased manufacturing programs, industrial licensing, and government purchase preferences.[14]

The rest of this section is dedicated to describing the import licensing system, so a brief explanation of the other controls is given here. *Canalization* is the creation of a trade monopoly, which reserves for a public-sector firm the exclusive right to import certain items. The *actual user policy* forbids imports by intermediaries, such as wholesalers. The importing entity has to prove that it is the end user of the good and is not importing for resale. *Phased manufacturing programs* allow imports of certain intermediate goods as inputs into production if they have no domestic manufacturers, but only for a set time frame, within which the company must either find a domestic alternate or produce the intermediate good itself. Finally, domestic goods were preferred for almost all government procurement and purchases.

The import licensing system divided commodities into three categories: consumer goods, intermediate goods, and capital goods. There was a near-total ban on the import of consumer goods. Those consumer goods that were deemed necessary but were not produced in sufficient quantities domestically were procured by government canalizing agencies. Intermediate goods were divided (on the basis of the stringency of restrictions) into the categories of "banned," "restricted," "limited permissible," and the OGL list. Capital goods were divided among two categories: "restricted" and the OGL list.[15]

To truly understand the horrors associated with the import licensing system, imagine a firm that wants to import either a capital good or an intermediate good that is not on the OGL list and thus requires a license. Import applications are reviewed on a case-by-case basis—each one is considered individually. The firm must first convince and certify to the Chief Controller of Imports and Exports that the imported good is "essential," a quality that is entirely subjective. Next, the firm has to obtain an "indigenous angle clearance" that certifies that there are no

[14] Pursell, "Trade Policies in India."

[15] World Bank, *India: An Industrializing Economy in Transition*, vol. 2, *Main Report*, Country Economic Report (Washington, DC: World Bank, 1987).

domestic alternates. The firm also has to prove that it is the actual user and that it is not importing the item for resale (this requirement was eventually phased out in 1977). Finally, under the phased manufacturing programs, the firm has to "agree to progressively replace imported materials, parts, and components with materials, parts, and components produced in-house or by other Indian firms."[16]

If, fortunately, a firm wanted to import an item that was included in the OGL list, the process was slightly easier, but the firm still had to meet four conditions:[17]

1) The firm is the actual user and cannot resell the item for at least five years.
2) The resulting change in productive capacity must be compatible with the capacity approved by the industrial licensing authorities.
3) The firm can import only items that are approved for the industrial cluster to which the firm belongs. For instance, a garment firm can import a machine that is approved under the OGL for the garment industry.
4) The imported equipment or machinery is not secondhand. (There are special permissions for secondhand items.)

How the Licensing System Worked in Reality

These confounding rules were compounded by the arbitrariness and subjectivity of decision-making by the officials in charge. Montek Singh Ahluwalia, in his book *Backstage*, gives a fascinating firsthand account of this arbitrariness.[18] A manufacturer of electric irons wanted to import a particular grade of stainless steel. The domestically produced steel sheets were too thick and would have made the iron heavy and nearly impossible to use. However, because there was a domestic alternate and the product was for domestic use, an import license was denied. If,

[16] Pursell, "Trade Policies in India," 437.

[17] Pursell, "Trade Policies in India."

[18] Montek Singh Ahluwalia, *Backstage: The Story behind India's High Growth Years* (New Delhi: Rupa, 2020).

however, the iron had been for export, the quality of the product would have been considered important and the import of the thinner sheets would have been allowed.

If a company was resourceful enough to obtain a license to import some required goods, it couldn't count its blessings and make long-term business plans. Instead, there was always a looming threat that government officials could change their minds about the import license. Consider the case of Sunil Mittal and his company, Bharti, which is a conglomerate today and has a big share in India's telecom market. In the company's early days, Mittal obtained a license to import portable generators. Given the unreliable nature of India's electricity supply, the generators imported from Suzuki Motor Company in Japan proved to be highly popular among consumers between 1982 and 1984. In 1984, the government of India, in one fell swoop, canceled the import license. The reason? Two domestic manufacturers got a license to produce the generators within India, and they managed to convince the government to ban the imports.[19]

The excessive domestic restrictions on industrial activity and nearly complete protection from competition through tight import controls and licensing succeeded in choking the life out of Indian manufacturing. Consider that Hindustan Motors, which had a near monopoly in the Indian automobile market with its flagship car, the Ambassador, was established at roughly the same time as the Japanese car giant Toyota. Fifty years after their founding, Toyota sells roughly 5 million cars a year worldwide, while Hindustan Motors sells 18,000 Ambassador cars, all sporting the same design and specifications as the first Ambassador.

The complex system of bureaucratic controls fostered an environment ripe for rent-seeking. While Indian businesses could not control the overall direction of policy, they could lobby and seek an exemption here and an added protection there. Getting a required-input raw material included in the OGL list could change the course of the company. Toward this end, "each major business house established the equivalent of an industrial embassy in New Delhi designed to act as a listening post, liaison office and lobbying agency to deal with political and bureaucratic

[19] Sunil Bharti Mittal, "Rise of the New Entrepreneurial Classes and the Emergence of a High-Growth Economy," in *India Transformed: Twenty-Five Years of Economic Reforms*, ed. Rakesh Mohan (Washington, DC: Brookings Institution Press, 2018).

decision makers."[20] Businesses spent considerable resources corresponding with, lobbying, and making representation to government ministers and officials. Gradually, businesses learned how to navigate the system and corner industrial licenses, secure monopoly control, and get assured protection from external competition.

Narayana Murthy, the founder and former chairman of Infosys Technologies, one of India's biggest IT companies, recounts the difficulty of trade in that period: "It used to take about 12 to 24 months and about 50 visits to Delhi (paying a red tape surcharge each time) to get a license to import a computer worth $1,500"[21]. In addition, there was a 150% import duty that had to be paid, which made the import cost three times the computer's cost in the United States, which made importing the computer unviable for any Indian business.[22]

Similarly, when Tata Motors got an industrial license to produce trucks in India, it had to make every single component, even if it didn't have the comparative advantage to do so, because importing components was an arduous and expensive affair. The engineering team had to import special pens to draw the blueprint for the trucks, and the total cost of the pens (excluding the red tape premium) was greater than the profit from selling a truck.

Piecemeal Liberalization in the Eighties

A process of slow, cautious, and piecemeal liberalization began around 1976, mainly characterized by the reintroduction of the OGL system. Between 1976 and 1988, the OGL list grew from 79 capital good items to 1,170 capital good items and 949 intermediate inputs. By

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[20] Stanley A. Kochanek, "Liberalisation and Business Lobbying in India," *Journal of Commonwealth & Comparative Politics* 34, no. 3 (1996): 157.

[21] Narayana Murthy, in "The Agony of Reform," chapter 4, episode 2 of *Commanding Heights*, PBS, 2002, https://www.pbs.org/wgbh/commandingheights/shared/minitext/tr_show02.html.

[22] Narayana Murthy, "The Impact of the 1991 Economic Reforms on Indian Businesses," in Mohan, *India Transformed*, 610–11.

April 1990, imports of items in the OGL list had come to account for approximately 30% of total imports. This was accompanied by an effective nominal rupee devaluation by around 45%.[23]

Of importance is the accompanying relaxation in the industrial licensing system, which had a strong trade component to it. By 1990, 31 sectors had been removed from industrial licensing controls. Machinery imports in these sectors were freed from the need for clearances. However, one point of concern was the steady increase in tariffs during this period to compensate for the loss of licensing rents.

Economic Impact and Long-Lasting Effects of India's Trade Policy

The effects of India's inward-looking and protective trade policy on its economy have been documented extensively in the literature and are perhaps well recognized in India. For the three decades after independence, the average annual growth rate of real GDP was roughly 3.5% and per capita income growth was 1.5%. The inward-looking and autarkic policies resulted in a shrinkage of India's share of world merchandise exports, from 2.2% in 1948 to 0.5% in the 1980s. The volume of India's exports grew at a paltry 2.7% annually (1950–1973), compared to the world average of 7.9% in the same period. The ratio of trade (imports plus exports) to GDP, which is a broad indicator of a country's integration with the world economy, was about 16% for India in 1948 and again in 1980s, having dipped to about 10% in between.[24]

Martin Wolf notes that "In the 1950s India had been the foremost exporter of manufactures among the developing countries. By the middle of the 1960s it was second, by 1970 it was third, and by 1978, seventh. In 1978 the Republic of Korea's manufactured exports exceeded India's by 200 per cent".[25]

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[23] Pursell, "Trade Policies in India."

[24] T. N. Srinivasan and Suresh D. Tendulkar, "Reintegrating India with the World Economy," Peterson Institute for International Economics, 2003.

[25] Martin Wolf, "India's Entry into the Global Economy," in Mohan, *India Transformed*, 92–93.

Though the effect of industrial and trade policies on industrial performance and GDP growth changed with the change in policies in 1991, it is astounding to look at some of the far-reaching consequences of the protectionist policies. The legacy effects can be witnessed even in 2021. According to a World Bank report, these policies have had a lasting effect on "(a) the structure of production, (b) the size distribution of firms, (c) the scale of production, (d) market concentration ratios, (e) overall product diversity and degree of import substitution, (f) product specialization at the firm level, and (g) the geographic dispersion of industry."[26]

A significant legacy issue is the preponderance of capital-intensive firms in India, which is a labor-abundant country. To be sure, a major part of the blame can be apportioned to India's restrictive labor laws and industrial policy, but some part of it can be reserved for import policy as well. India's protective regime led to the "establishment and growth of a number of highly capital-intensive industries in which India would not appear to have a comparative advantage and which have and continue to absorb a disproportionate share of national savings."[27]

In a similar vein, the cause for the absence of medium and large enterprises in India today can be traced back to the industrial and trade policies of the pre-liberalization era. The regulatory barriers to entry, growth, and exit were substantially lower for small firms than for medium or large ones. Finally, the set of regulatory and financial concessions given to industries categorized as small-scale ensured that many firms stayed small. This policy bias toward small firms, which has significant consequences for India's employment scenario, has not entirely disappeared even in 2021.

The 1991 Reforms

The fiscal profligacy of the late 1980s, the rising current account deficit, high external debt, inflation rates hovering around 10%, short-term debt reaching 147% of foreign exchange reserves, the fall in foreign exchange reserves until they covered barely 10 weeks of imports—all

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[26] World Bank, *India: An Industrializing Economy in Transition*, 55.

[27] World Bank, *India: An Industrializing Economy in Transition*, 55.

of these combined heralded a macroeconomic crisis for India. This part of the story and the dramatis personae are relatively well known and thus need not be expounded in this essay.

The International Monetary Fund's assistance came through and macroeconomic stabilization occurred swiftly and, by 1993, many of the macro indicators had values that would be considered acceptable. Srinivasan and Tendulkar discuss the immediate response to the 1991 crisis and the macro stabilization:

> The gross fiscal deficit of the central government fell from 7.9 percent of GDP in 1990 to 5.6 percent by 1992, nonoil imports declined by 22 percent in 1991, and the current account deficit dropped from 3.2 percent of GDP in 1990 to 0.3 percent in 1991. The stock of short-term debt was reduced from 146.5 percent of foreign exchange reserves in March 1991 to 76.7 percent by 1992 and 64.5 percent by 1993 (table 2.2). Real GDP growth dipped from 5.6 percent in 1990 to 1.3 percent in 1991 during this period of fiscal contraction but recovered quickly to 5.1 percent in 1992."[28]

The import cover of foreign exchange reserves rose to more than eight months, from 2.5 months in 1990/91. The debt service ratio fell from 35.3% in 1990/91 to 25.6% in 1993/94. Private capital flows picked up and assistance from international agencies such as the World Bank and the International Monetary Fund declined.

The macroeconomic stabilization was accompanied by a range of long-term structural reforms in the areas of fiscal discipline, the monetary and financial sector, capital markets, the exchange rate mechanism, industrial policy and licensing, foreign investment, and, finally, trade policy. It is the last part that this essay will focus on.

Rupee Devaluation and Moving toward a Market-Based Exchange Rate

The rupee had been depreciating in real terms year on year in the late 1980s. Even so, it was still overvalued when it was time to deal with the balance-of-payments crisis at hand, and a significant devaluation was necessary. Wary of political repercussions à la 1966, then prime

[28] Srinivasan and Tendulkar, "Reintegrating India," 30.

minister Narasimha Rao undertook the devaluation in two steps and in secrecy. Code-named "Hop, Skip and Jump," the maneuver first devalued the rupee by 9% on July 1, 1991, to gauge public reaction. The rupee was further devalued two days later, taking the cumulative devaluation to about 19%.[29]

Subsequently, in March 1992, the government also established a dual exchange rate system. Under this regime, the government allowed importers to pay for some imports with the rupee valued at the free-market rate, while there was also a government-mandated rate of exchange for other imports. The two exchange rates were unified a year later, and the rupee was allowed to float for the very first time in its history.[30]

Import Liberalization

In one fell swoop (or so it seems), the Narasimha Rao government eliminated the import licensing system in July 1991. Capital goods, intermediates, components, and industrial raw materials were almost entirely opened up for import by manufacturers and retailers, for stock and sale.[31] Finally, the approach changed from protecting Indian industry to providing it with an opportunity to compete in world markets. Consumer goods, accounting for 30% of all tariff lines, constituted the exception in the case of import licensing until 2001, when India's trading partners lodged a challenge at the World Trade Organization.

India began removing balance-of-payments-related quantitative restrictions unilaterally in 1996, when quantitative restrictions on 488 items were removed. A further 391 items lost restrictions in 1997 and 894 items in 1998, and the rest of the restrictions were removed by 2001. Simultaneously, the proportion of canalized items (reserved for import by government agencies

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[29] Ahluwalia, *Backstage*.

[30] Reserve Bank of India, *The Reserve Bank of India*, vol. 4, *1981–1997* (New Delhi: Academic Foundation, 2013); Devika Johri and Mark Miller, "Devaluation of the Rupee: Tale of Two Years, 1966 and 1991" (working paper, Centre for Civil Society, 2010).

[31] Tejendra Khanna, "Trade Policy Reforms: The Indian Experience," in *Trade Policy Issues*, ed. Chorng-Huey Wong and Naheed Kirmani (Washington, DC: International Monetary Fund, 1997).

only) in total imports in value terms declined from 27% to 19% during the ten-year period from 1988/89 to 1997/98. From 1999 onward, the number of items in the prohibited and restricted categories was also significantly reduced.[32]

Tariff Rates

In 1990/91 the highest tariff rate stood at 355%, the simple average of all tariff rates at 113%, and the import-weighted average of tariff rates at 87%. The budget speech delivered by Manmohan Singh on July 24, 1991, announced a drastic reduction in the peak tariff rates, to 150%. The rate was further reduced to 110% in 1992/93, 85% in 1993/94, 65% in 1994/95, and 50% in 1995/96. Agriculture remained highly protected after the first round of reforms, with the weighted average import duty rates higher in 2001/02 than in 1991/92. Other measures also show the protection that agriculture has enjoyed.[33]

The customs duty collection rate fell from 47.0% in 1990/91 to 44.0% in 1991/92, and it declined further, to 37.0%, in 1992/93. There was also a gradual reduction in nontariff barriers on imports. In 1988 nontariff barriers covered 95% of imports in sectors covered in a World Bank study; the number had declined to 24% by 1999.[34] Table 1 shows the weighted average tariff rates of India for various broad import groups. It can be seen that the average tariff rate (last column) steadily declined from 1991 till 1996, then edged up again, which was driven by increases in tariff rate on consumer goods and agricultural products.

Table 1. Weighted Average Import Duty Rates in India (%)

Year	Agriculture	Mining	Consumer goods	Intermediate goods	Capital goods	All commodities
1991/92	47.0	56.9	97.8	69.5	94.8	72.5
1992/93	22.8	32.6	83.2	62.6	85.2	60.6
1993/94	19.8	33.4	68.7	47.6	58.4	46.8

[32] Reserve Bank of India, External Sector, Annual Report, 2003.

[33] Srinivasan and Tendulkar, "Reintegrating India."

[34] World Bank, *India: Reducing Poverty, Accelerating Development*, World Bank Country Study (New Delhi: Oxford University Press, 2000).

1994/95	16.8	30.3	55.9	38.4	45.5	38.2
1995/96	16.7	29.9	36.1	22.9	29.1	25.9
1996/97	14.7	22.0	39.0	21.9	28.8	24.6
1997/98	14.0	21.9	33.8	46.1	25.1	25.4
1998/99	24.2	19.9	37.9	31.1	29.4	29.2
1999/00	24.4	21.4	37.4	33.1	31.0	31.4
2000/01	58.6	16.1	56.2	36.2	34.4	35.7
2001/02	57.7	15.8	67.1	34.8	31.8	35.1

Source: Reserve Bank of India, External Sector, Annual Report, 2003.

In 2021, India's tariff rates range from 0% to 150%, with 67.8% of all tariff lines between 0% and 10%, 22.1% higher than 10% and up to 30%, and 4.0% above 30%. The most common tariff rates continue to be 10% (31.7% of tariff lines) and 7.5% (24.4% of tariff lines).[35]

A noteworthy feature of India's tariff rates in the early 1990s was that, though they had been reduced from extremely high levels, they were still relatively high (particularly for nonagriculture) compared with existing levels in comparable economies.[36] India still had the highest tariff rates among emerging markets at the turn of the century, as table 2 shows.

Table 2. Tariff Rates among Emerging Markets

Country	Year	Simple mean tariff rate	Standard deviation of tariff rates	Weighted mean tariff rate
China	1992	41.0	30.6	32.2
	2000	16.3	10.7	14.7
Indonesia	1989	21.9	19.7	13.0
	2000	8.4	10.8	5.2
Malaysia	1988	17.0	15.1	9.4
	1997	9.3	33.3	6.0
Philippines	1989	28.0	14.2	22.4
	2000	7.6	7.9	3.8
Thailand	1989	38.5	19.6	33.0
	2000	16.6	14.1	10.1
India	1990	79.0	43.6	49.6
	1999	32.5	12.3	28.5

[35] Asit Ranjan Mishra, "WTO Urges India to Reduce Tariffs," *Mint*, January 7, 2021.

[36] Harsha Vardhana Singh, "Trade Policy Reform in India since 1991" (Working Paper 02, Brookings India, New Delhi, 2017).

Note: *Simple mean tariff rate* is the unweighted average of the effectively applied rates for all products subject to tariffs. *Standard deviation of tariff rates* is the average dispersion of tariff rates around the simple mean. *Weighted mean tariff rate* is the average of effectively applied rates weighted by the product import shares corresponding to each partner country.
Source: Reserve Bank of India, External Sector, Annual Report, 2003.

Deb Kusum Das provides an overview of the reform process: protectionism has declined "from around 82 per cent [of] industries exhibiting Effective Rate of Protection (ERP) levels of more than 100 per cent in 1990–91 to around 80 per cent of industries having ERP levels of less than 20 per cent in 2009–10."[37] The other trend that emerges for both tariff and nontariff barriers is that the preference was to deregulate and ease imports of capital goods first and intermediate goods next, while consumer goods had *relatively* high rates of protection throughout the post-reform period.

Impact of the Import Liberalization

Any appraisal of the impact of trade liberalization on the economy must emphasize that reforms in trade occurred alongside reforms in multiple other domains. A growth in exports following the reforms of 1991 can be attributed as much to the freeing up of imports as to the removal of strict industrial licensing and the abolition of the Monopolies and Restrictive Trade Practices Act. Similarly, the higher trend growth post-1991 has many causal factors.

Broadly, liberalizing imports has had an impact on overall trade—its direction, composition, and volume—and on industrial performance—its efficiency, productivity, and growth.

Impact on Trade

The obvious effect of the trade reforms is the growth in the volume of trade. India's share in world exports increased from 0.5% in the 1980s to 0.8% in 2002, and India's exports of goods and services have grown faster than the world's post-1991. Equally important is the growth rate

[37] Deb Kusum Das, "Trade Policy and Manufacturing Performance: Exploring the Level of Trade Openness in India's Organized Manufacturing in the Period 1990–2010" (DRG Studies Series, Reserve Bank of India, Mumbai, 2016). The effective rate of protection is the percentage excess of domestic value-added, vis-à-vis world value-added, introduced because of tariff and other world barriers.

of imports—from 5.9% a year in the 1980s to 9.2% the next decade. The ratio of total exports of goods and services to GDP in India rose from 7.3% to 14.0% pre- and post-liberalization. Imports also saw an increase, but to a lesser extent: from 9.9% in 1990 to 16.6% of GDP in 2000. Meanwhile, the ratio of total trade in goods and services to GDP increased from 17.2% to 30.6%.[38]

Though some of the strictest controls on import licensing were removed in 1991, the tariff rates, as discussed earlier, were not reduced as rapidly. Significant tariff reduction occurred in the decade after 2000, and the growth of real imports, significantly higher in that decade than in the 1990s, reflects this.

With liberalization of imports and the reduction of export subsidies and other distortions, India has been able to diversify its export basket. In the 1970s, four industries (textile products, food and beverages, basic metals, and leather and leather products) dominated the export basket, adding up to 80% of total exports. This drastically declined to 20% in 2009.[39] Manufactured exports increased from an average of 60.7% of total exports in the 1980s to an average of 76.1% of total exports after the crisis.[40]

The direction of trade has changed as well. On the export side, the major shift has been away from Japan and Russia and toward developing Asia. The share of developing countries in Asia, Africa, and Latin America increased from 14.2% to 30.9% (1987/88 to 2001/02). The shares of the United States and the European Union in India's exports have increased, while their shares in imports have declined. Overall, the major shift in imports has been away from Russia, the United States, and Europe and toward OPEC nations and other developing countries. Between 1987/88 and 2001/02, imports from OPEC rose from 13.3% to 25.9% of India's total imports, and those

[38] Panagariya, "India's Trade Reform."

[39] United Nations Conference on Trade and Development, *Twenty Years of India's Liberalization: Experiences and Lessons*, ed. Rashmi Banga and Abhijit Das, United Nations Publication UNCTAD/OSG/2012/1, 2012.

[40] Arvind Virmani, "India's 1990–91 Crisis: Reforms, Myths and Paradoxes" (working paper, Planning Commission, Government of India, New Delhi, 2001).

from developing countries rose from 17.3% to 29.2%.[41] As expected, India's trade with China—both imports and exports—has increased significantly.

Output, Productivity, and Efficiency Gains

In terms of overall gains from trade liberalization, it is generally difficult to isolate the effects of one set of reforms from those of others. Econometric models that attempt to estimate overall gains come with a few caveats and assumptions. Having said that, Rajesh Chadha et al. offer perhaps the most comprehensive estimate of the effects of trade liberalization on India's GDP and, by extension, on the welfare of Indian people. In their 1998 paper, they look at the effects of trade reforms in three different scenarios:[42]

1) *Administered version:* Trade liberalization is carried out while retaining the product market imperfections, such as state-controlled monopolies and administered prices.

2) *Market version:* Competition exists, state monopolies are removed, and prices are determined by the market.

3) *Rationalization of taxes and subsidies:* The conditions of the market version apply, and distortions such as indirect taxes and subsidies (agriculture, water, gas, electricity, etc.) are removed or reduced.

The results were stark then and hold lessons for today as well. Import reforms can permanently increase GDP by 1.60%, while import and export reforms can increase it by 2.01% under the administered version. Under the market version and rationalization of taxes and subsidies, import and export reforms can increase GDP by as much as 5.00% and 5.15%, respectively.

Crucially, the returns to the factors of production increase in similar ratios to GDP. For instance, under the third scenario, undertaking import and export reforms can lead to an increase in returns to land, labor, and capital by 4.6%, 5.2%, and 5.5%, respectively.

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[41] Panagariya, "India's Trade Reform"; Srinivasan and Tendulkar, "Reintegrating India."

[42] Rajesh Chadha et al., "Analysis of India's Policy Reforms," *World Economy* 21, no. 2, (1998).

Arvind Panagariya discusses three other channels through which efficiency gains take place.[43] First, the dismantling of the import substitution system allows for the availability of higher-quality substitutes for low-quality domestic goods. This will lead to the emergence of new products and sectors in the country, which can compete in world markets. Second, even for domestically produced goods, the availability of new and high-quality inputs can lead to significant efficiency gains, which were lost during the import substitution regime. Third, welfare gains through the expanding of choice for consumers, with the replacement of sometimes poor-quality domestic goods with higher-quality imports, can be substantial.

Pravin Krishna and Devashish Mitra find strong evidence of an increase in competition (as reflected in the reductions in price-marginal cost markups) and some evidence of an increase in the growth rate of productivity in India following the 1991 reforms.[44] Jagadeesh Sivadasan finds productivity increases of 30%–35% in industries that benefitted from trade liberalization. He also finds a 25% increase in aggregate output growth and a 20% increase in aggregate productivity growth following tariff liberalization.[45]

Petia Topalova and Amit Khandelwal attempt to establish a causal link between trade liberalization in India and productivity growth. They find that "pro-competitive forces, resulting from lower tariffs on final goods, as well as access to better inputs, due to lower input tariffs, both appear to have increased firm-level productivity."[46] Interestingly, the access to better inputs has had the largest impact. They also emphasize the positive interplay between reduction in tariffs on the one hand and foreign direct investment liberalization and domestic industrial deregulation on the other. The impact of tariff reduction is significantly higher in the presence of the other two components.

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[43] Panagariya, "India's Trade Reform."

[44] Pravin Krishna and Devashish Mitra, "Trade Liberalization, Market Discipline and Productivity Growth: New Evidence from India," *Journal of Development Economics* 56, no. 2 (1998).

[45] Jagadeesh Sivadasan, "Barriers to Entry and Productivity: Micro-evidence from Indian Manufacturing Sector Reforms" (PhD diss., Graduate School of Business, University of Chicago, 2003).

[46] Petia Topalova and Amit Khandelwal, "Trade Liberalization and Firm Productivity: The Case of India," *Review of Economics and Statistics* 93, no. 3 (2011): 995.

T. N. Srinivasan and Suresh Tendulkar look at two summary indicators, the shares of wages and exports in total sales, from a comprehensive study of Indian firms by the National Council of Applied Economic Research (NCAER):

> In general, the export orientation of the corporate units has indeed increased during the postreform period. The export ratio, a sign of increased international competitiveness, has increased in all the industry groups, except electrical machinery. The wage share has declined, to varying degrees, in all of the 17 industries covered by the NCAER study. This is consistent with increased export orientation, which is associated with higher productivity per worker and more efficient utilization of labour.[47]

Pinelopi Koujianou Goldberg et al. find a fascinating insight using detailed trade and firm-level data. Aside from finding significant productivity gains from trade through access to new imported inputs, they find that "lower input tariffs account on average for 31% of the observed increase in firms' product scope over this period."[48]

Finally, Michele Alessandrini et al. look at the change in production structure of industries post-liberalization. Their paper shows that the structure of comparative advantage of industries in India has substantially transformed during this period. "Specifically, the technological content of trade has shifted gradually from low-technology sectors toward medium-technology sectors."[49] The key insight from this paper is that the largest improvements in trade specialization have occurred in industries that experienced the largest reduction in import tariffs.

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[47] Srinivasan and Tendulkar, "Reintegrating India," citing National Council of Applied Economic Research, *The Impact of India's Economic Reforms on Industrial Productivity, Efficiency and Competitiveness: A Panel Study of Indian Companies, 1980–1997* (New Delhi: NCAER, 2001).

[48] Pinelopi Koujianou Goldberg et al., "Imported Intermediate Inputs and Domestic Product Growth: Evidence from India," *Quarterly Journal of Economics* 125, no. 4 (2010): 1728.

[49] Michele Alessandrini et al., "Tariff Liberalization and Trade Specialization in India" (working paper, Asia Development Bank, 2009).

Covered here is just a sample of the literature on productivity and efficiency gains from import liberalization, mainly through the channels of increased access to input goods and increased competition.

Conclusion

The period surrounding the 1991 reforms was undoubtedly a watershed moment in Indian economic history, and it is useful to remind ourselves repeatedly about the circumstances that led to the crisis, the response to the crisis, the bold reforms undertaken, and the effects of those reforms. The reforms have helped to foster increased trade and exports, greater manufacturing specialization, productivity and output, and greater consumer choice. The welfare gains, in short, have been tremendous.

Despite the clear successes, there are two regrets oft-repeated by economists and policy wonks—that we didn't do enough in reforming certain aspects of the economy and that we have reversed the gains of reforms on other aspects. On the first count, factor markets (land and labor) were not reformed at that time perhaps owing to the politically-sensitive nature of the reforms and continue to be organized in a highly inefficient manner today. Foreign direct investment liberalization happened in random spurts over the next 30 years. The capital account remains quite tightly regulated and the Reserve Bank of India has undertaken unsuccessful defense of the rupee on several occasions. Though the average effective rate of tariffs has declined over the years, some sectors, such as food and beverages, remain highly protected.

There have been numerous policy reversals and sometimes abrupt U-turns, which necessitate that we learn from the 1991 episodes. The language of 2020 bears a growing resemblance to that of the prereform period—including talk of self-sufficiency (Atmanirbhar) and import substitution (Make in India). Protection of Indian industry against global competition has increased in the past few years in the form of increased tariffs and duties. India continues to employ significant nontariff barriers and has liberally levied antidumping duties. Refusal to join multilateral trade agreements because of the fear of competition is a telling signal of India's position and how much more needs to be achieved.