A E P R Asian Economic Policy Review JCER

doi: 10.1111/j.1748-3131.2008.00112.x *Asian Economic Policy Review* (2008) 3, 266–285

The Role of Trade and International Economic Policy in Indian Economic Performance*

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India's economic policies have undergone major reforms since the early 1990s. Before that, government regulation and control of economic activity was pervasive, and the trade sector did very poorly. One consequence was that imports were highly restricted and their scarcity was itself a major constraint on growth. After the crisis of the early1990s, trade policy was substantially liberalized. In this paper, the pre-1990s regime is first briefly described. Thereafter, the economic policy reforms that impinged most directly on the trade sector are set forth, and the response of exports and imports to those changes is outlined. Exports have grown rapidly, from about 5% of the gross domestic product to around 15%, and they continue to grow at an average annual rate of 20%. Improved performance of the trade sector has been a major contributing factor to India's dramatically accelerated growth performance. A final section of this paper assesses the current situation, and sets forth the major policy challenges that will need to be met if that performance is to be sustained, if not improved upon.

Key words economic policy reform, Indian economic policy, Indian exports and imports, India's trade, trade liberalization

JEL codes F1, O1, O2, O5

1. Introduction

India's accelerated growth rate in the recent past has caught the world's attention. After independence and more than three decades of sluggish growth, averaging around 3–4% annually, the growth rate picked up – first to 5–6% in the 1980s and then, after a major balance of payments crisis in the early 1990s, it rose to about 7% in the late 1990s and has averaged almost 9% over the past several years.

By any standard, Indian economic performance has greatly improved; per capita incomes have risen much more rapidly than in earlier years as the rate of growth of population has fallen while the rate of increase in output has risen; and the absolute number and fraction of people living in poverty, while still large, has fallen dramatically. Indian participation in the international economy has increased, with greatly reduced barriers to international transactions.

However, there are a number of questions: What were the factors accounting for the shift in economic performance? How sustainable is the current growth rate? And what is

*This paper was presented at the Conference on the New India, Sixth Asian Economic Policy Review Conference, Tokyo, April 19, 2008.

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the likelihood that the growth rate can accelerate further, to 9–10% annually, which is the government's official objective?

And, central to this paper, what has been the role of policies toward international trade and capital account transactions, and of the external sector's performance in affecting Indian economic growth?

To assess these issues, it is necessary first in Section 2 to review the earlier growth performance and the economic policy framework, especially with regard to the foreign sector, within which it took place. Without an appreciation of the pre-reform policy stance, it is difficult to analyze and evaluate the reforms and their effects. It will be seen that Indian trade policy was highly restrictive and central to the growth strategy that was being pursued. It was also a major factor in India's poor growth performance. Next comes an examination of the policy changes, especially with regard to the external sector, and responses to them, since the 1980s. The fourth section then addresses the current situation. The final section assesses the prospects for the future.

2. Indian Economic Performance and Policy up to the 1990s

Although India achieved independence in 1947, disruptions associated with partition and the establishment of a new government initially occupied center stage. Even in 1950/51,[1] when the First Five Year Plan (FFYP) was promulgated, it consisted largely of a listing of infrastructure and other governmental projects already under way. It was not until the formulation of the Second Five Year Plan (SFYP), which covered the years 1956/57 to 1961/62, that the broad outlines of Indian economic policy that would dominate until the 1980s were laid.

Most Indian economic data do not go back before 1950/51 (or are of dubious quality) and that year is an adequate starting point for analysis.[2] Table 1 gives the evolution of real gross domestic product (GDP) over the years, as well as the share of gross domestic capital formation in GDP and an index of agricultural production. In 1950, it is estimated that considerably more than 70% of the population lived in rural areas, and that agriculture accounted for about 56% of GDP. Per capita income was among the lowest in the world, life expectancy at birth was estimated to be about 32 years, and the literacy rate was 18% (27% for males and 9% for females). By any standard, India was a very poor country. Gross domestic savings were about 8% of GDP; exports were just over 6% of GDP.

During the period of the FFYP, considerable attention was given to economic policy under the leadership of Prime Minister Jawarhalal Nehru, and the direction was set which was to be followed for the next several decades. It was decided that there should be a "socialist pattern of society", that the government should take a leading role in the economy, and that economic growth was a foremost objective of the state. To this end, a Planning Commission was established, with the Prime Minister at its head (in practice, the Deputy Chairman of the Planning Commission, with Cabinet rank, led and leads the Commission). The Planning Commission set output targets for a wide array of commodities from bicycles and candles to trucks and heavy chemicals. It was not entirely clear, at least initially, how these targets were to be met. In some cases, public sector firms were established and/or expanded. In others, it was expected that expansion would come from (controlled) private sector firms.

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Table 1 Indicators of long-term Indian economic performance, 1950–2007

	Gross national product at factor cost (1990–1991 prices)	Per capita income (1990–1991 prices)	Index of agricultural production† (1979–1980–1981–1982 = 100)	Gross domestic capital formation (GDCF)† (percentage of GDP)
	Average annual growth			
1951–1956	3.7	2.6	46.2	8.4
1956–1961	4.0	1.7		
1961–1966	2.8	0.4	68.8	14.0
1966–1969	3.9	1.6		
1969–1974	3.4	0.8	85.9	15.1
1974–1979	5.0	2.6		
1979–1980	–5.0	–8.2		
1980–1985	5.4	3.1	102.1	19.9
1985–1990	5.5	3.3		
1990–1992	3.2	1.0	148.4	26.0
1992–1997	6.6	4.5		
1997–2002	5.5	3.3	165.7	24.3
2002–2007	7.8	6.1	197.1‡	35.9‡

†Numbers are for first fiscal year of decade. The GDCF number is preliminary.
‡Data for 2006–2007.
Source: Ministry of Finance (2008), Appendix Tables 1.2 and 1.3A.

Quickly, however, industrial licensing was established, which set the licensed capacity of private firms and specified the maximum amount they could produce. For many years, it was illegal for a firm to produce more than its licensed capacity, and expansion licenses were granted only in conformity with plan targets.[3] And the government of India (GOI) delineated industries that were to be in the public sector, industries that could have both public and private participation, and those that would be "reserved" for the private sector.[4]

Although the implications for international trade policy of the plans do not seem immediately to have been clearly understood, the prevailing attitude toward foreign trade was one of great suspicion. The SFYP was designed to shift the orientation of Indian industry to the production of heavy industry and, in particular, "machines to make machines."[5] The investment goods needed to establish this capacity were heavily import intensive, and the industries themselves were relatively capital intensive. The plan envisaged a sizable increase in investment. The combination of these factors resulted in a sharp increase in imports and, with it, a "balance of payments crisis" in 1956/57.[6] From thereon out, it was judged that "foreign exchange shortage" was the chief bottleneck to growth. Rather than adjust the exchange rate, restrictive exchange controls were imposed. An import licensing regime was established under which firms had to apply for import licenses, and to

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demonstrate to the authorities that domestic production capacity was not available for these goods. In addition, high tariffs were imposed even on those goods whose imports were permitted.[7]

Despite these measures, by 1966 there was again a "crisis", as the imports needed to carry out planned investments and to provide intermediate goods and raw materials for new industries would have required much more foreign exchange than was available. On that occasion, the rupee was devalued, although, as documented in Bhagwati and Srinivasan (1975), the devaluation was flawed in a variety of ways. But the trade regime was, if anything, even more restrictive shortly after the devaluation than it had been before.

During the years when global prices (in US dollar terms) were stable or rising by at most 2–3% annually, Indian inflation was in the range of 5–10%. The result was that over time the rupee became increasingly overvalued, making imports ever more profitable for those who could obtain licenses, and providing less and less incentive to produce for export markets. Consequently, exports grew relatively slowly, and fell as a percentage of GDP from 6.2% of GDP in 1950–1951 to 3.2% of GDP in 1964–1965.[8] India's share of world markets had fallen, and would continue to fall, until the 1980s.

Those policies adopted by the GOI aimed directly at curbing imports would by themselves have resulted in a trade sector diminishing in importance over time. Incentives were highly skewed toward import substitution, where the Tariff Commission and import licensing procedures virtually assured profitability to anyone producing for the domestic market. Pursell *et al.* (2007) estimate that the average level of nominal protection in manufacturing was 120% in 1986, rising to 130% in 1992 before starting to decline after reforms took place (see discussion below). These tariffs were often greater than the price differential between Indian products and those available on the international market, but there was a complete prohibition on imports of most consumer goods, and quantitative restrictions and other non-tariff barriers were the instruments effectively constraining imports. When a product was available domestically, import licenses were not granted.

Between the first two balance of payments crises, the real exchange rate appreciated as Indian inflation exceeded world inflation. There was thus gradual appreciation of the currency in real terms until the 1965–1966 devaluation episode; it thereafter remained fairly constant until 1986 after which real depreciation began, and accelerated until 1993 (Pursell *et al.*, 2007). In general, exports grew more rapidly during periods of real exchange rate depreciation, but nonetheless they were well below the levels that might have resulted from relatively uniform incentives for import-competing and export production (Joshi & Little, 1994). Few producers would have built or expanded capacity based on expectations of sales to the export market.

In addition, a number of other economic policies contributed to the marginalization of India in international trade. The large industrial houses, which were among the more efficient producers of some goods, were highly constrained by government policy and permitted to expand only in areas deemed essential where there were no other qualified producers. At the same time, the GOI wanted to protect small-scale producers, and adopted a "Small-Scale Reservation Law" (SSR) which essentially extended a number of special privileges to small-scale producers in a large number (at its maximum over 1 200) of

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industries and prohibited other producers from competing with them (although existing firms were grandfathered at their existing capacities and permitted to increase their output for export).[9] Most of the SSR industries were labor intensive, as documented by Mohan (2002). Thus, in many industries where India might have been thought, given its abundant supply of unskilled labor, to have an incipient comparative advantage, large firms were precluded from entering, and small firms were confronted with a choice of staying small or losing their special privileges.

Three other sets of policies also deterred efficient production and exports. These were a neglect of infrastructure, regulations governing the labor market, and the "license raj" itself which imposed high costs on economic activity.

Indian infrastructure was woefully inadequate. Not only were roads, railroads, and ports heavily congested, but communications were extremely poor. Overseas telephone calls were virtually impossible and even obtaining a telephone was a difficult and time-consuming undertaking. Infrastructure quantity and quality remains a major problem in many areas (but not telecoms where reforms were successful) and will seriously affect India's future economic growth and integration into the world economy unless it is seriously alleviated. Further discussion is therefore postponed until the final section of this paper.

The labor market was highly regulated, and in many ways. Firms in the "organized sector" (which were virtually the only ones that could have exported) were not permitted to fire workers. Union and worker rights were enshrined in law and union activity often disrupted production.

The "license raj" meant that private sector producers had to spend much of their time seeking the necessary licenses for imports, for exports, for capacity expansion, and other things. Even when licenses were granted, there were often delays, and considerable effort had to be devoted to obtaining the necessary permits.

Over the years prior to 1990, various ad hoc efforts were made to encourage export growth and to rationalize the trade regime. Most of these had at most marginal effects, as the bias in incentives toward import-substitution remained huge. The evolution of exports is set forth in Table 2. As can be seen, they fell to a low of less than 4% of GDP by the 1970s. The restrictiveness of the regime intensified with even the modest "Hindu rate of economic growth" as demand for imports rose with incomes far more rapidly than the rate of growth of export supply.

As a consequence of these (and other) policies, overall economic growth was relatively slow, as noted at the outset. Total factor productivity growth in manufacturing is estimated to have been negative until the 1980s, and to have been 0.3% annually for industry as a whole (Bosworth & Collins, 2008), in large part a consequence of inefficiencies resulting from entrepreneurs' efforts to substitute domestic inputs for those obtainable abroad and from the failure of Indian firms to utilize even their existing capacity because of "foreign exchange shortage."[10] Lack of competition also undoubtedly contributed.

The system was inefficient and uneconomic in many ways. Delays in getting licenses, spare parts, etc., resulted in frequent shutdowns even of new factories in new industries as there were delays in receiving the relevant licenses.[11] As the restrictiveness of the regime

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Table 2 Indian exports, export growth, and share of gross domestic product (GDP)

	Exports (Rs crores)	Annual change (%)	GDP (Rs thousand crores)	Exports as percentage of GDP
1950–1951	606		9.7	6.2
1960–1961	642	0.5	16.4	3.9
1970–1971	1 535	9.7	42.7	3.6
1980–1981	6 711	16.3	132.9	5.0
1990–1991	32 553	17.5	507.5	6.4
1991–1992	44 041	35.3	584.1	7.5
1992–1993	53 688	21.9	669.9	7.5
1993–1994	69 751	29.9	780.1	8.9
1994–1995	82 674	18.5	912.2	9.1
1995–1996	106 353	28.6	1 069.8	9.9
1996–1997	118 817	11.7	1 247.6	9.5
1997–1998	130 100	9.5	1 388.7	10.4
1998–1999	139 752	7.4	1 601.1	8.7
1999–2000	159 561	14.2	1 771.1	9.0
2000–2001	203 571	27.6	1 902.2	10.7
2001–2002	209 018	2.7	2 077.6	10.1
2002–2003	255 137	22.1	2 244.7	11.4
2003–2004	293 367	15.0	2 520.0	11.6
2004–2005	375 340	27.9	2 855.3	13.1
2005–2006	456 418	21.6	3 249.6	14.0
2006–2007	571 779	25.3	3 760.3	15.3
2007–2008†	448 337	7.7	na	

†April–December.
Source: Ministry of Finance (2008). 1 crore = 10 million.

intensified, incentives for smuggling and other evasions of the system increased, which in turn led to tighter inspections for applications licenses for investment projects and import consignments. There was also a virtual monopoly position for import-substituting firms dependent on imports of raw materials and intermediate goods: even if there was more than one producer, each firm's share was virtually determined by the import licenses received.

Bureaucratic delays, often resulting from a desire to be important or to give the appearance of impartiality, were a part of the "license raj", where obtaining licenses was the key to profitability. Licenses and permits were needed for most activities: investment itself, as already indicated, as well as for imports. But paperwork was associated with every transaction, including exporting (where one concern was to prevent under invoicing and, thus, to deter capital flight), finance, and even transport.

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Table 3 Trade and capital account balances ($ million)

Period	Trade balance	Current account balance	Capital account balance	External assistance	Private flows†	NRI deposits
1950s	–489	–265	126	106.0	29	0
1960s	–938	–831	845	852.0	48	0
1970s	–1 303	–29	615	662	151	85
1980s	–7 363	–4 414	3 932	1 487	1 393	1 135
1990s	–10 356	–4 368	7 822	1 515	5 168	1 328
2000s	–22 331	1 584	16 290	–71	13 090	2 253
2003–6	–33 087	809	23 402	346.0	18 856	1 822

†Sum of foreign investment and commercial borrowing.
Source: Reserve Bank of India (2007).

Capital inflows until the 1990s were almost entirely official, mostly development assistance (see Table 3). The GOI discouraged foreign direct investment (FDI) in a large number of ways, prohibiting it unless it was deemed that something "essential" – usually technology – was brought to the country that could not otherwise be obtained. Even then, conditions were stipulated (less than 40% of equity might be owned by foreigners, FDI could take place only in specified "priority" areas, requirements for technology transfer, etc.) that made FDI unattractive.[12] IBM and Coca-Cola made headlines when they withdrew from their investments in India because of unacceptable conditions for their continued operations.

As import-substituting firms were dependent on raw materials, intermediate goods, and capital goods in order to produce many of the import-substituting products (and expand productive capacity), the GOI struggled to issue as many licenses as possible to industrial users. As a consequence of this, and the rapid growth of demand for imports, the current account was in virtually chronic deficit. Table 4 traces the evolution of the trade balance and Table 3 the balance of payments. As can be seen, the trade balance was negative in all years (including those not listed) except for 1976–1977. It peaked, as a percentage of GDP in the year of India's first post-independence "balance of payments crisis" in 1956–1957 at 4.8% of GDP, remained in the 3–4% range in the 1960s, rose again in response to the oil and commodity price increases of the early 1970s (and increasing rupee overvaluation), and was again in that range in the 1980s. Table 3 presents estimates of the trade balance, and current and capital account balances by decade. Even here, the data do not indicate the magnitude of the "foreign exchange shortage", as import licenses were constrained to a considerable degree by the availability of foreign exchange. For most of the period, the trade and current account balances would have been much larger negative numbers had there been freedom to carry out desired transactions at prevailing prices. As can be seen from Table 3, virtually the entire capital inflow prior to the 1980s was from official sources.

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Table 4 Evolution of India's trade balances (Rs crores)

	Exports	Imports	Trade balance	Trade balance as percentage of gross domestic product
1951–1952	716	890	–174	–1.7
1956–1957	605	841	–236	–4.8
1961–1962	642	1122	–480	–3.7
1966–1967	1157	2078	–921	–3.1
1971–1972	1608	1825	–217	–4.7
1976–1977	5142	5074	68	0.1
1981–1982	6711	12 549	–5838	–3.8
1986–1987	10 895	19 658	–8763	–3.1
1991–1992	32 553	43 198	–10 645	–2.1
1996–1997	118 817	138 920	–20 103	–1.6
1997–1998	130 100	154 176	–24 076	–1.7
1998–1999	139 753	178 332	–38 580	–2.4
1999–2000	159 561	215 236	–55 675	–3.1
2000–2001	203 571	230 873	–27 302	–1.4
2001–2002	209 018	245 200	–36 181	–1.7
2002–2003	255 137	297 206	–42 069	–1.8
2003–2004	293 367	359 108	–65 741	–2.6
2004–2005	375 340	501 065	–125 725	–4.4
2005–2006	456 418	660 409	–203 991	–6.2
2006–2007	571 779	840 506	–268 727	–7.1

Source: Ministry of Finance (2008). 1 crore = 10 million.

When Rajiv Gandhi became Prime Minister in 1984, his stated intention was to "rationalize" the licensing system. There was modest liberalization of the licensing system both regarding control of industry (as firms were permitted to produce at levels above those permitted in their industrial licenses and the size of firm needing a license was increased) and the import and export regime. For example, investments and imports of less than a specified amount were permitted without the necessity of obtaining a license. In addition, after 1986 the effective real exchange rate depreciated steadily, from about 140 (with 1980/81 = 100) in 1986 to over 170 in 1990 (and almost 220 in 1993).[13,14] Pursell *et al.* (2007) estimate that there had already been real depreciation of about 70% between 1985/86 and the crisis of 1991/92. Not only did this real depreciation encourage exports during the latter half of the 1980s, but it facilitated the reforms, and especially the import liberalization, of the 1990s and later years. By the early 1990s, tariffs were a far more important component of protection of domestic industry than they had been in earlier years as higher import prices absorbed part of import demand and, thus, quantitative restrictions had less bite.

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3. Policy Reforms After 1991–1992

During the 1980s, then, there had been some degree of relaxation of the stringency of the exchange control regime, and some real depreciation of the rupee. However, during the 1980s, there had also developed a huge macroeconomic imbalance. The fiscal deficit of the central government had averaged around 4–5% of GDP in the latter half of the 1970s, rose to about 8.5% of GDP in 1985/86, and remained at that level into the early 1990s. The deficits of the state enterprises and the states increased at a similar pace. The result was a rapid buildup in public debt, both internal and external, and rising inflation rates. The inflation rate rose above 10% by 1991–1992. The current account deficits rose to over 3% of GDP during the late 1980s. Although growth during the 1980s rose to an average annual rate over 5%, it was unsustainable in light of the expansive macroeconomic policies and the buildup of debt. Reforms had clearly also contributed to accelerated growth in the 1980s, although the Indian economy remained heavily overregulated and constrained by any reasonable standard. It is against this background that the reforms of the 1990s must be understood.

By early 1991, a major macroeconomic crisis emerged. Although the roots of the problem were primarily macroeconomic, the precipitating factor was a sharp drop in foreign exchange reserves, which was accompanied by a cutoff in private foreign lending and a downgrading of India's credit rating.[15] Despite an International Monetary Fund (IMF) loan in January 1991, the situation did not stabilize immediately. After the assassination of Prime Minister Rajiv Gandhi, a new minority government was formed in June 1991 with Prime Minister P. V. Narasimha Rao and with Congress Party the single largest party in the new parliament.

The new government was committed to structural reforms but had, of necessity, to address macroeconomic imbalances first. A new IMF loan supported the reform package, which included a 19% devaluation of the rupee (although inflation reached 14% in 1991), and an abolition of export subsidies.[16,17] Tight controls on imports were retained, however, and bad weather in 1991–1992 resulted in a poor harvest. The result was that the dollar value of exports did not immediately increase. However, the tight fiscal situation, with the deficit dropping from 8.3% of GDP in 1991/92 to 5.9% of GDP in 1992/93, the slowdown in GDP growth, and the rupee devaluation all contributed to a drop in imports, so that the current account deficit fell from 3.2% of GDP to 0.4% of GDP in the following year.[18]

The policy changes after 1991/92 went far beyond those accompanying earlier balance of payments crises. Many factors contributed to this greater scope and depth. First, there was the severity of the crisis itself – it is estimated that foreign exchange reserves were no more than 2 weeks' imports when initial measures were taken.[19] Second, it was evident that fiscal deficits had been the major factor contributing to the crisis (private saving as a percentage of GDP had remained unchanged during the 1980s) and had to be sharply curtailed. Third, over time there were more and more Indians who expressed unease or discontent with India's slow growth, as first the East Asian tigers, then South-East Asia and China all recorded sharply accelerated growth rates. Fourth, the disintegration of the Soviet Union further altered perceptions and undermined support for state dominance of

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economic activity. But fifth, and perhaps most important, the economic policy team led by Finance Minister Manmohan Singh and backed by Prime Minister Narasimha Rao was convinced that economic reform was essential if India was to improve its economic performance. Because of the crisis, there was more than the usual room for maneuver, as opponents of reform were weakened or discredited. But, even then, as described by the reformers themselves, it was "reform by stealth." Except for the sharp initial change in the fiscal balance and, to a lesser degree, the exchange rate depreciation, reforms proceeded relatively slowly.

Structural changes began to take place in 1992. For purposes of analyzing the current and capital account, the most important were those affecting trade – tariffs, the exchange rate, and non-tariff barriers – and capital flows. For capital flows, many of the reforms that had major impact were of the domestic monetary system which was significantly liberalized.

For trade, quantitative restrictions were mostly abolished on imports of intermediate and capital goods in 1992. This in itself was a huge change. At the same time, tariff reduction began and restrictions on FDI and inward portfolio investment were eased.[20,21] In the early years after the crisis and initial reforms, the main effect seems to have been a surge in private capital inflows. Foreign exchange reserves were rebuilt rapidly. By 1993–1994, export growth accelerated, with exports increasing by over 20% annually from that year onward. As can be seen from Table 2, exports as a percentage of GDP rose from their 7.5% level at the beginning of the decade to 10.4% of GDP in 1997–1998. Then, after 2 years of slower growth, they continued increasing as a share of GDP at least through 2006–2007, the latest year for which data are available, and were more than 15% of GDP in that year.

In addition, after the rupee devaluation of the early 1990s, the exchange rate was determined by a combination of market forces and intervention, in such a way that the real exchange rate remained within a fairly narrow range of about 10%. It was widely recognized that this was a part of the new policy package, and relative certainty about the future of the real rate may have been as important as the level in providing incentives for foreign traders.

There was one major change in infrastructure during the reform period, which certainly had a positive impact on the external sector. It did not really become effective until early in the 21st century. That was reform of telecoms, which resulted in vast improvement in both internal and external telecommunications. Whereas shouting from hotel rooms had been a frequently heard phenomenon in earlier years as people tried to make themselves understood (if they connected at all), deregulation, permission for private entry into the cell-phone market, and a separation of the regulator from the state provider all resulted in a much-improved environment. To this day, the rate of telephone usage, and especially cell phones, is rising more rapidly in India than in virtually any other country, although there remains a long way to go before the cell phone–population ratio reaches anywhere near the Chinese level.

Although there have been efforts to increase infrastructure capacity in other areas, the rapid growth of real GDP has meant that congestion and delays in all transport modes were as frequent as ever, if indeed the situation did not deteriorate. The costs, delays, and uncertainties surrounding transport remain an obstacle of significance for domestic and foreign trade, a topic to which attention returns in the final section.

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For imports, the 1990s saw a virtual complete dismantling of controls over producers' imports, but imports of consumer goods remained prohibited in almost all instances. However, by 2002, import prohibitions were almost entirely removed after a World Trade Organization (WTO) dispute over them was resolved. Tariffs were gradually reduced as well. There was some offset to this liberalization, as para tariffs were imposed in some instances, and the GOI began using antidumping and other measures frequently to raise protection levels.[22] There was even a "war room" in the Ministry of Commerce to monitor imports of some 300 "sensitive" items to determine whether imports were "disrupting domestic production." Soon, however, it became evident that the "damage" from imports was significantly less than had been anticipated as maintenance of a realistic value for the rupee and the reduced costs of production associated with import liberalization enabled much more adjustment than had been expected.

As a result of this increased confidence, the monitoring of imports was dropped and, starting in 2004, further tariff reductions were undertaken. Pursell *et al.* (2007) estimate that, currently, the average protection for manufactures is on the order of about 15%.[23] While this is a sea change by a huge order of magnitude from the pre-1990s situation, Indian tariffs are still high by standards of many emerging markets. The WTO estimated that, in 2005, the simple average of Indian most favored nation tariffs on manufactures was 18.3%, with a bound average of 49.8% (which gives the GOI a great deal of latitude to raise rates if they so choose). By comparison, China's average bound and applied rate is 10%, South Korea's is 11.2%, and bound and applied rates in industrial countries average less than 5% (Martin & Mattoo, 2008).

Aside from the changes enumerated above, and a host of measures that relaxed controls over foreign trade in other ways, there were numerous other reforms in the years following 1991. For example, there were reductions in the amount of paperwork required in order to obtain export finance or permission to export. But perhaps even more important, there were systematic efforts to reduce the paperwork and controls governing economic activity in general, a change in attitude toward the private sector, and increasing confidence that success in industry would not be penalized. While this helped all of Indian industry, it was especially important for the foreign sector. However, as will be discussed below, bureaucratic requirements and delays still constitute a significant hurdle for those entering into transactions with foreigners.

4. India's Trade and Capital Flows in Recent Years

Reforms were dramatic during the first few years after 1991, and reform momentum continued, or was renewed, on a number of fronts up until the past several years. While there has been little backsliding, the momentum for reform seems to have been lost shortly after the coalition government led by Prime Minister Manmohan Singh came into office in 2004.

To be sure, some measures have been undertaken. The GOI has entered into a number of preferential trading arrangements [PTA]), primarily with South and South-East Asian nations. Agreements with Sri Lanka and Singapore date from the 1990s, but others are

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either in the process of negotiation or in the early stages of implementation. India has signed a South Asian Free Trade Agreement (SAFTA) but there are a number of issues remaining to be negotiated. The country is also committed to a preferential arrangement with the Association of South-East Asian Nations (ASEAN). To a considerable extent, India's trade has been relatively geographically diversified, and the decision to enter into PTAs was defensive, as PTAs were proliferating worldwide. The share both of intraregional trade and trade governed by PTAs remains relatively small.[24]

Although India had been a founding member of the GATT/WTO, India's stance had historically been supportive of the multilateral system but insistent upon special treatment for developing countries and resistant to any liberalization. Since the opening up of the Indian economy, India has focused on agriculture and the difficulties India would have in reducing protection for its agriculture in the Doha Round of trade negotiations. India and Brazil have been two key participants from emerging markets in the Doha Round, but the GOI has resisted the lowering of its bound tariffs to the currently applied rates even in manufacturing, and remains a supporter of the developing countries' positions on issues such as special and differential treatment, trade facilitation, and intellectual property rights.

A second recent trade initiative has been the move toward Special Economic Zones (SEZ). The intent was to enable exporters to avoid much of both the bureaucratic red tape governing transactions and the restrictive labor laws. The intent is to promote the development of large-scale manufacturing of unskilled labor-intensive goods. The legislation permitting SEZs was passed in 2005 and regulations for implementation were promulgated early in 2006. It is thus too soon to evaluate their effect. However, in the winter of 2007, licenses granting SEZ status were suspended for several months as strong political objections were raised on the grounds that farmers were losing their lands and that large and/or rich enterprises were using the legislation to obtain land inappropriately.

By the time of writing, the foreign trade regime has been radically reformed from its pre-1991 highly restrictive stance. Tariffs were, as already seen, still high by standards of other emerging markets, but an official target was to bring them down to ASEAN levels in the near future. Moreover, protection levels were very low compared to those existing in the 1980s especially as quantitative restrictions had been almost entirely phased out.[25] However, while tariffs on manufactures had fallen sharply, tariffs and non-tariff barriers on agricultural commodities remained steep, averaging 40% at the time of the last WTO *Trade Policy Review* (2007). The removal of quantitative restrictions and huge tariff reductions lessened the restrictiveness of the regime enormously. There had been a partial offset, at least in the early 2000s, as antidumping measures came to be used. Panagariya (2008) presents evidence that between 1995 and 2005, India was the largest user of antidumping measures, with a cumulative 425 initiations. By contrast, the USA (the second largest user) had initiated 366 cases, the European Community 327, and the fourth largest, Argentina, had introduced 204 cases. There is some evidence that resort to antidumping measures has diminished in recent years.[26]

Restrictions on foreign providers of services remained largely unchanged. Estimates by the Australian Productivity Commission put trade restrictiveness indices for India at

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59.9 for banking, 68.9 for telecoms, and 60.5 for maritime services, with lower but still high numbers for distribution (32.3), accountancy (44.3), and other services.[27] These contrast with numbers for industrial countries in banking where the highest restrictiveness index number was 19.4 (Japan), and in distribution where France's number was 32.7, Japan's and Germany's were both close to 25, but other countries had much lower numbers.

The response in the foreign trade sector was much greater than even the optimists anticipated. As already seen, export earnings rose dramatically, and India was much more integrated into the world economy, although its share of world exports was still low (at 1%) contrasted with its share in the early 1950s. Although there is some indication that export growth may have slowed in the last half of 2007 and early 2008, merchandise export growth averaged over 20% annually from 2003–2004 to 2005–2006, the last year for which data are available. In addition, service exports grew exceptionally rapidly, more than doubling in each of the three most recent years. Indeed, in 2005/06, India had a positive services balance equal to 3% of GDP.

Foreign investment also rose sharply in response to the relaxation of conditions and improved incentives. Annual FDI inflows rose from $3.13 billion in 2002/03 to $5.6 billion in 2005/06, while inward portfolio investment, which had been less than $1 billion as recently as 2002/03, rose to $12.5 billion in 2005/06.

For both trade in services and inward foreign investment, a major development was the rapid growth of the information technology (IT) sector in India. Starting from a very low level in the early 1990s, it increased in importance, as world-class firms, such as Infosys and Wipro emerged, and outsourcing to India became increasingly important for many firms in industrial countries.[28] Expectations are that robust growth of the sector will continue, although the very exceptionally high rate of growth may decline as labor shortages and other bottlenecks are appearing.

IT service exports grew from about $800 million in 1995/96 to $17.3 billion in 2005/06 and rapid growth continues. Total software exports were $23.6 billion in 2005–2006, and constituted 39% of total services exports.[29] In turn, India's share of world exports of services was 2.5%, reflecting the achievements in this area.

Some observers have questioned whether the success of Indian IT services was the result of government intervention and government policies. In fact, however, the opposite seems to be the case: the IT sector started its rapid growth period without significant government encouragement. Indeed, a major factor seems to have been that it is a service industry that was not subject to significant government regulation during its early period. Hence, it was able to become established with much less government intervention than was the case with many other industries. In addition, the IT industry was much less dependent on Indian infrastructure than were most other manufactures. Satellite communications were a major vehicle for transmission of product between foreign buyers and Indian providers. The success of the Indian IT sector exceeded all expectations of what India could achieve, and has resulted in a considerable increase in optimism about India's economic capabilities. This last may be the most important contribution of the IT sector to India's economic policy and growth prospects.[30]

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5. Prospects for India's Future Economic Integration

It was already stated that momentum for reform has dwindled sharply in the past 3 or so years. For the future, the key questions are whether the reform momentum has largely stalled for the foreseeable future and, if so, what are the growth prospects and what reforms are needed in the short to medium run to maintain or accelerate growth.

There are a number of reasons for believing that the current growth rates of 7–9% cannot be sustained over the medium term without further reforms. To be sure, the business environment and incentives for efficiency are greatly improved over those that existed two decades ago and it is unlikely, even if reforms are completely stalled, that India would return to the "Hindu rate of growth" of the 1960s and 1970s. But some of the rapid growth of the past decade has been the result of the reduction in the extent of distortions and the greater efficiency (and, hence, greater investment in some instances) that firms have been able to achieve in consequence. To maintain, or better yet, increase growth momentum will require further reforms in a number of areas.

There remains much to be done. The Indian economy was so repressed and regulated for the period up to 1980 that relaxation of controls (with reasonable assurance that they would not be reinstated) was bound to enable a significant jump in the growth rate. And there is certainly momentum from the growth of the past 15 years in response to past reforms that will enable continued growth over the foreseeable future. But the opportunities arising from removal of some of the inefficiencies of the old regime will surely reach diminishing returns, if they have not already done so, without further reforms.[31]

The best way to make the case that growth at its current high rates cannot be sustained, much less accelerated, is to analyze some of the key policy issues that still hinder efficient use of Indian resources, with emphasis on those most affecting foreign economic relations. With regard to trade, a first concern is that tariffs remain high relative to standards of the 21st century. Experience in all countries shows that tariffs raise costs of needed inputs for exporters, making them less competitive in world markets. As already seen, Indian agricultural protection remains high, and there are sizable inefficiencies resulting from subsidization of inputs (especially fertilizer), price controls, and other interventions.[32] But it is in services where there remain perhaps the largest opportunities for further reform of the trade regime on current account.

There are also many other challenges. Although much has been done to simplify the procedures and rules governing the operation of businesses in India, there are still many obstacles to efficient operation. The World Bank (2007) publishes an annual *Doing Business*, which ranks countries on a variety of dimensions that gives some indication of how "business friendly" the country is. Many of these indicators – property protection, the number of days it takes to obtain needed licenses to start a business, the time and cost of enforcing contracts – are good, albeit not perfect, proxies for government regulations that raise costs. India has improved both absolutely and in the rankings with regard to other countries. In the 2008 edition, India was ranked 120 (out of 180 countries) in terms of the ease of doing business. India was rated very poorly in dealing with licenses, where there are 20 procedures (for the typical activity for which estimates were made for all countries) taking

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224 days and costing more than five times per capita income. Delays in contract enforcement, closing a business, and the costs and time involved in paying taxes were areas where India scored particularly badly. For example, firms must still register to be in the "organized sector" and procedures are cumbersome.[33]

Another area of great concern, as already indicated, is India's creaking infrastructure. India's infrastructure deficit imposes a cost in terms of efficiency on almost all economic activities, but is certainly a major constraint on competitiveness in among tradable goods. Perhaps the most extreme difficulties pertain to electric power. Rotating electric outages and brownouts are a fact of life in many parts of India. Producers have to some extent compensated (at high cost) by installing their own generating equipment. But for sustained growth of output, both of tradables and nontradables, improved access to reliable power sources will be vital, and that will require rapid capacity expansion.

There are also major challenges with respect to means of transport. Despite some significant improvements (the road network has been upgraded with the construction of the Golden Quadrilateral connecting the four major cities of New Delhi, Mumbai, Chennai, and Kolkata), growth has been so rapid that congestion remains high. Delays in truck and railroad shipments, port congestion, and high costs of domestic transport all reduce India's international competitiveness. It is only in telecommunications where it can be claimed that the reforms have been sufficient to address major shortcomings and enable the sector to grow at a rate sufficient to accommodate rapid economic growth.

These concerns affect all of Indian economic activity, but are particularly important for exporting activities. In addition, there are several overriding macroeconomic concerns that would affect India's growth prospects and, hence, the outlook for exports. First among these, and in the short to medium term, is the fiscal situation. Although the fiscal deficit was reduced in the first few years after the crisis of 1991, it again increased, and with it, public debt. Much of this debt was incurred because of the states' fiscal situations, while the central government deficit has fallen considerably. But current indications are that government expenditures may increase rapidly in response to a Pay Commission Report just issued, planned forgiveness of debts owed by many farmers, rising international prices of commodity imports (where government subsidies to domestic consumers are already significant), and other decisions anticipating the elections in 2009. Given the terms of trade deterioration associated with high oil prices, the existing level of government debt, and inflationary pressures within India, macroeconomic stability must be a concern. Domestic debt of the GOI is over 80% of GDP, and much is already held in the banking system.

India's biggest asset and source of comparative advantage in trade should be its abundance of unskilled labor. But there two major, interrelated issues. Between them, it seems evident that they constitute a significant deterrent to accelerated growth and the major explanation of why India has to date failed to experience rapid growth of exports of unskilled labor-intensive goods.

The first issue is education. Many regard the poor quality and even the quantity of education as a major bottleneck for future growth. While there are some outstanding educational programs at all levels, the education system as a whole is in need of considerable reform (see Chapter 20 of Panagariya, 2008, for a discussion).

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The second deterrent to development of unskilled labor-intensive manufacturing is the regulatory framework governing employment in India. Employment in the "organized sector", which encompasses all large business and from which most exports of goods must originate, has decreased since the early 1990s as output has expanded through increasing capital intensity, rather than through additional employment, despite India's abundance of labor. Of all the employment in 1999/2000, 95.6% was in the informal sector (Panagariya, 2008, p. 285). Once a firm is large enough so that it should be in the formal sector, it is subject to regulations governing all aspects of employment. Firms with more than 100 workers may not dismiss any. And an Industrial Disputes Act gives labor unions very strong powers to bring production to a halt even over very minor grievances. It is noteworthy that India's growth rate of manufacturing output has accelerated, but that employment in manufacturing is little changed while investment has been strong: employers have been substituting capital for labor to avoid problems with their labor unions.

The challenge of finding policy reforms to enable India's unskilled labor-intensive manufacturing to grow more rapidly, especially for the export market, is perhaps the biggest single hurdle to achievement of an even higher growth rate than has been realized in the past several years. Failure to address labor market issues, including union rights, requirements governing employment, and education, will prevent the emergence of another major stimulus to economic growth. Without reforms in this area, it is unlikely that growth rates any higher than those realized in recent years can be achieved.

6. Conclusions

The Indian economy of 2008 bears little resemblance to that of two decades ago. Much has been accomplished, including importantly the reduction, if not removal, of the pessimism regarding India's ability to compete in world markets that characterized economic policies for the first decades after independence.

Although much has been done, there remains much to do. Should Indian economic policies continue in about their present form, it is likely that growth might decelerate to a 5–6% rate. If, however, the optimism (hopefully not euphoria) generated by the results of reforms to date provides sufficient impetus to further reforms in a new government, the Indian economy could accelerate growth. If it did, India would have a number of advantages: a political system and democracy with gradual reform and consensus, the "demographic dividend" as the percentage of population in the labor force will rise, etc., as demonstrated by achievements in IT so far. This would, of course, require sustained reform as well as government efforts to empower infrastructure, education, and to reduce further the bureaucratic hurdles to which private business is subject.

Perhaps the most important risk to achieving India's potential is that success to date may result in euphoria and belief that the task of reform is already completed. It is to be hoped that, instead, success to date will convince the Indian body politic of the desirability and likely high payoff of continuing down the reform path. In that case, India's importance and role in international trade and the world economy will continue to increase, with attendant success in reducing poverty and raising living standards.

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Notes

1 The Indian fiscal year starts on April 1 and ends on March 31; most economic data are recorded on the basis of the fiscal years. For that reason, I shall follow the practice in this paper, denoting the year from April 1, 199x, to March 30, 199x + 1 as 199x/x + 1. When calendar years are indicated, data refer to the January–December period.
2 Unless otherwise indicated, the data given here are from the Ministry of Finance, Government of India (2008, various appendix tables).
3 In practice, large companies applied for additional capacity licenses often without the intent of using them, but with the intent of precluding other firms from increasing their permitted output. That, in turn, led to additional policies designed to curb the role of the "large industrial houses" in the economy.
4 See Bhagwati and Srinivasan (1975) and Panagariya (2008, Chapter 13) for descriptions and analysis of the effects of these policies.
5 In 1938, Nehru had already stated that "the three fundamental requirements of India, if she is to develop industrially and otherwise, are: a heavy engineering and machine-making industry, scientific research institutes, and electric power. These must be the foundations of all planning" (quoted in Srinivasan, 2000, p. 1).
6 India had initially held large sterling balances built up during the Second World War, but these had rapidly run down.
7 See Bhagwati and Desai (1970) and Bhagwati and Srinivasan (1975) for description and analysis of the trade and exchange regime.
8 It is interesting to note that India's exports were larger than Japan's as late as 1952. In 1953, Japan's exports exceeded India's by 16%; by 1964–1965, Japan's exports were 6.6 times those of India (data from International Monetary Fund, 1983).
9 For an excellent analysis of the effects of SSR, see Mohan (2002).
10 As pointed out by Bhagwati and Srinivasan (1975), firms applied for licenses to expand capacity even when existing capacity was underutilized, as they could then prevent competitors or newcomers from receiving licenses.
11 One estimate is that the average length of time from start to completion of public sector infrastructure investment projects rose from about 1–2 years during the FFYP period to as much as 5–8 years by the 1980s.
12 See Agrawal (2003, pp. 118–120) for a brief description of policy toward FDI.
13 Estimates in the rest of this paragraph are from Pursell *et al.* (2007, figure 3). Estimates for later years are given in Table 5.
14 Joshi and Little (1996) conclude that the real appreciation in the early 1980s led to stagnation of exports in the first half of the decade, and that it was the real depreciation of the second half of the 1980s that induced the rapid increase in exports during those years. Since oil prices had increased significantly in 1979–1980, appropriate exchange rate policy would have entailed a depreciation of the real exchange rate, even if it had been at an appropriate level in the late 1970s. Since the balance of payments was determined much more by the import licensing regime than by market forces, it is impossible to estimate what an "appropriate" exchange rate might have been.
15 See Joshi and Little (1994, 1996) for analyses of the causes of the crisis.
16 In March 1992, a dual exchange rate system was started in which exporters received the market rate. The exchange rate was unified in March 1993, with an effective devaluation of about 40% in nominal terms and 25% in real terms over the 2-year period, see Table 5.
17 An import entitlement scheme for exporters was also introduced.

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Table 5 Nominal and real exchange rates (1993–1994 = 100)

	6-country index		36-country index	
	Nominal EER	Real EER	Nominal EER	Effective EER
1994–1995	97.0	105.8	98.9	104.3
1995–1996	88.6	101.3	91.5	98.2
1996–1997	86.9	101.1	89.3	96.8
1997–1998	87.9	104.4	92	100.8
1998–1999	77.5	96.1	89.1	93
1999–2000	77.2	97.7	91	96
2000–2001	77.4	102.8	92.1	100.1
2001–2002	76	102.7	91.6	100.9
2002–2003	71.3	97.7	89.1	98.2
2003–2004	70	99.2	87.1	99.6
2004–2005	69.6	101.8	87.3	100.1
2005–2006	72.3	107.3	89.9	102.4
2006–2007	68.9	105.5	85.9	98.5
Nov. 2007	73.8	114	93.7	108.4

Source: Ministry of Finance (2008), Table 6.6, GDP data from Table 1.1 p. A3.
EER, effective exchange rate.

18 The primary deficit (the deficit net of interest payments) fell from 4.3% of GDP in the crisis year to 1.6% of GDP in the following year.

19 The rise in the price of oil and reduction in workers' remittances associated with the first Gulf War no doubt increased the sense of crisis.

20 Since there was a great deal of water in some of the very high tariff levels prevailing, it is likely that few of the initial tariff reductions resulted in lower domestic prices of import competing goods. Prohibitions on imports of consumer goods remained in effect for another decade.

21 The capital inflow and resulting foreign exchange receipts complicated macro policy. The authorities chose to risk inflation and maintain the nominal exchange rate, rather than risk undermining the incipient growth of exports.

22 See Pursell *et al.* (2007) for an account. The WTO (2007) reports over 200 antidumping measures in force in 2003 when their use peaked although there remained close to 200 measures in force 2 years later, the last year for which the data are reported.

23 This means, inter alia, that much of the redundancy in Indian tariffs ("water in the tariff") has disappeared, and that many of the tariffs are now binding, with Indian manufacturers facing the fluctuations in international prices of their goods. But the levels bound under the WTO are much higher than the applied tariff in most cases.

24 The interested reader can see WTO (2007), where a list of agreements under negotiation or coming into force is provided. Even for Sri Lanka (the earliest agreement), there was zero duty for 1 000 tariff lines, a 50% margin of preference for all other items except for 429 items on a negative list. For textiles, the tariff is 25% the MFN rate, while tariff quotas applied to tea, garments, and *vanaspati*.

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25 India has also entered into a number of PTAs, almost entirely with South and South-East Asian neighbors. These were only beginning to affect tariffs and other trade barriers in late 2006 and 2007 (see WTO, 2007, p. 23, for a discussion).
26 The largest proportion of antidumping cases was against chemicals and chemical products (41.2%). Plastics and rubber products were the second largest group with 16.5% (see WTO, 1997, p. 51).
27 Productivity Commission, Australia, Measures of Restrictions on Trade in Services Database.
28 The IT sector initially flourished in Bangalore, but has since begun growing rapidly in other cities including especially Hyderabad and Chennai. Bangalore was not as congested as the largest Indian cities, had a tradition of good engineering universities and technical training, and relatively good infrastructure by Indian standards. One of the reasons for the emergence of other cities as IT centers has been that Bangalore's success has resulted in hugely increased pressures on infrastructure services.
29 Tourism receipts have grown, although not as rapidly as IT services. Foreign exchange purchases for tourism, transport, and other services have grown at about the same rate as have expenditures.
30 For an analysis of the IT sector, see Saxenian (2002).
31 For a more pessimistic assessment, see Acharya (2007).
32 However, the GOI prevents exports of food grains to moderate domestic prices to consumers. See, for example, Alan Beattie and Javier Blas, *The Financial Times*, 14 April, 2008, p. 7.
33 See Forbes (2002) for a discussion of how the environment for business had improved by that time, but also for how much remains to be done.

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