

# A Decade of Trade Reforms in India

How it compares with East Asia

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The strategic objective of Indian policy makers at the outset of independence was the creation of a self-reliant economy and the reduction of the high levels of poverty that existed, all within a democratic political framework. In order to achieve these objectives, the authorities steadfastly pursued a Socialist strategy of state-directed, heavy industry based industrialisation complemented by an across-the-board import substitution policy, financial repression and complex industrial requirements. Notwithstanding some notable successes, the highly statist and interventionist development policies adhered to during this period of insulation led to a severely distorted production structure. While growth did pick up in the latter half of the 1970s, the Indian economy was generally mired in a vicious circle of low productivity/product obsolescence and slow growth. Not only was the performance of the Indian economy well below the targets set by the planning authorities, the country was left lagging in terms of economic growth and development relative to its East Asian neighbours such as China and Korea, which had broadly similar levels of per capita income at the time of India's independence (Kelkar, 2001).

Although some tentative steps were taken in 1985 to liberalise and unshackle the economy by delicensing a few industries, these partial and rather *ad hoc* measures contributed to the creation of severe and unsustainable macroeconomic imbalances in the Indian economy, particularly with regard to escalating fiscal deficits. The imbalances corresponded to a

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period of severe political instability and uncertainty following three successive minority governments during 1989–91. While the fragilities in the Indian economy were largely homemade, the shock of the 1990 Gulf war was the single factor which “broke the camel’s back” as India was brought to the brink of an international default, something that had never occurred in its post-independence history. Faced with a severe balance of payments crisis as foreign exchange reserves plummeted to US\$1 billion in late June 1991, barely sufficient to cover a fortnight’s worth of imports, India entered into an IMF structural adjustment program. In addition to the conventional expenditure switching and reducing policies, as part of the IMF agreement, a range of far-reaching economic policy reforms was launched in July 1991 in the external, industrial, financial and public sectors.

These reforms appear to have paid significant dividends at the macro-economic level. The Indian economy recovered smartly from the crisis, real GDP growing at an annual average rate of 6.4 percent between 1992 and 1998 (Table 1). Not only was this a marked improvement from India’s own past, it was the second highest rate of growth in the world behind China. Of equal importance to the pace of growth is the “quality of growth”. As Desai (2000) has noted, “the Indian economy appears to be...sound... Something has changed; we are no longer in the boom-and-bust mode of the 1960s, 1970s or 1980s” (p.4). This in turn may be partly attributable to the fact that post-1991 growth was driven principally by an expansion of private investment while national savings simultaneously rose, thus ensuring that there was no significant pressure on the balance of payments position (compared with the consumption-led growth of the mid to late 1980s).

This paper concentrates on the impact of India’s economic reforms in the 1990s on its international trade linkages with the rest of the world. The next section briefly summarises recent trade reforms in India, and documents the extent to which the country has integrated with the global trading system and compares its performance with selected East Asian economies. As part of India’s newfound global orientation, trade in services has taken on a key role, constituting over a quarter of India’s total exports in 1999/2000 (Raipuria, 1999). Within the services sector, the Information and Communications Technologies (ICT) sector is of particular relevance. This sector is seen as a means of “leapfrogging” the stages

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Table 1: India's growth performance compared with East Asia, 1980-98

	India		China		Indonesia		Korea		Malaysia		Philippines	
	1980-89	1990-98	1980-89	1990-98	1980-89	1990-98	1980-89	1990-98	1980-89	1990-98	1980-89	1990-98
GDP at factor cost (constant 1995 US\$ billion) (C.A.G.R)	5.7	5.8	6.7	6.7	10.6	10.6	N.A	5.4	9.2	5.4	N.A	N.A
GDP at factor cost (current US\$ billion) (C.A.G.R)	5.2	3.8	8.7	8.7	N.A	13.0	2.5	-1.7	15.2	3.1	N.A	3.8
GDP at market prices (constant 1995 US\$ billion) (C.A.G.R)	6.0	5.6	6.4	6.4	10.1	10.1	6.4	4.6	9.0	5.3	5.6	6.4
GDP at market prices (current US\$ billion) (C.A.G.R)	5.3	3.7	8.5	8.5	6.1	13.2	3.0	-2.4	15.1	3.0	5.0	6.8
GDP per capita, PPP (current international \$) (period average)	923.2	1732.6	1830.2	793.0	2255.3	1176.4	2537.8	4796.8	12007.9	3622.3	7324.4	2514.8
												3372.3

Note: C.A.G.R indicates Compound Annual Average Growth rates over the specified time periods.  
Source: Computed from World Bank (2000).

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of trade and development that is characteristic of the FGP pattern. We therefore discuss the role of the ICT sector in India which has hitherto been the bulwark of the country's export growth. The final section offers a summary and a few concluding remarks.

## **India's merchandise trade patterns in the 1990s vis-à-vis East Asia**

### **More liberal trade policy**

Prior to 1991, India was the archetypical import substituting regime with "one of the most complicated and protectionist regimes in the world" (IMF, 1998). However, following steps towards the unshackling of its trade regime, India's simple average tariff rate has come down significantly from 128 percent in 1991 to about 34 percent in 2000. The trade-weighted tariffs declined from 87 percent in 1991 to around 30 percent by 2000, while the maximum tariff rate fell to 45 percent in 1997, having hovered at 355 percent in 1991. More precisely, India's trade liberalisation efforts can be broadly divided into two periods. The first five years from 1991 to 1996 was a period of intense liberalisation as tariffs fell dramatically. The second half of the 1990s can at best be characterised as a period of consolidation of, but definite deceleration in, the pace of tariff compression in general; the average tariff rate remained largely unchanged. In fact, while the simple average tariff rate remained more or less constant, there was a slight increase in the trade-weighted tariffs from a low of 25 percent in 1996 to 30 percent by 2000. Without attributing causation, it is interesting to note that this corresponds to the decelerating trend in economic growth in the latter half of the 1990s compared with the first five years since the crisis of 1991 (IMF, 1998).

While being fully cognizant of the fact that the recently announced reforms will take time to fully come into effect, it is fair to ask if and to what extent the decade long reforms have been successful in integrating India with the global market economy.

### **'Flying Geese' pattern of comparative advantage and foreign direct investment (FDI)**

Table 2 compares some of India's external sector economic indicators with those of selected East Asian economies (the ones considered here are

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Table 2: External sector indicators for India and East Asia, 1980–98 (period averages)

	India			China			Indonesia			Korea			Malaysia			Philippines		
	1980	1990	-89	1980	1990	-89	1980	1990	-89	1980	1990	-89	1980	1990	-89	1980	1990	-89
Exports of goods and services (% of GDP)	6.0	9.7	10.4	21.0	21.0	25.9	29.8	29.8	35.0	31.4	58.2	89.0	24.7	37.0				
Exports of goods and services (annual % growth)	5.3	11.1	19.1	14.9	14.9	2.0	9.2	9.2	11.6	13.8	9.6	11.9	7.9	7.9				
Share in World Exports (%)	0.5	0.6	1.3	2.4	2.4	0.9	0.9	0.9	1.5	2.2	0.7	1.2	0.3	0.3				
Share in World Trade (%)	0.6	0.6	1.3	2.2	2.2	0.8	0.8	0.8	1.5	2.2	0.7	1.2	0.3	0.4				
Manufactures exports (% of merchandise exports)	60.3	65.2	34.0	81.1	81.1	14.3	46.4	46.4	91.4	92.6	31.0	70.0	27.7	59.7				
Trade (as % of GDP)	14.5	21.9	21.5	39.5	39.5	48.1	57.2	57.2	69.8	62.9	113.9	176.1	51.0	80.6				

Source: World Bank (2000)

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China, Korea, Indonesia, Malaysia, and the Philippines) in two distinct periods, 1980–89 and 1990–98.<sup>1</sup> The following general observations may be delineated on the basis of available data.

India has been able to gradually increase its share in global merchandise trade and exports from 0.58 percent and 0.44 percent in 1980 to 0.74 percent and 0.69 percent, respectively, in 1999. While this increase may not appear particularly striking at first, it is, considering that India's share in world merchandise trade was more or less on a declining trend during the early 1990s. Between 1990 and 1999 India's merchandise trade and exports grew at an annual compound average of 8.2 percent and 9.0 percent, respectively. Since this growth was matched by an expansion of the overall economy, India's level of openness, as proxied by the trade to GDP ratio, has remained more or less constant over the past few years at 0.25 (though this was almost 70 percent higher than that in 1980).

These improvements notwithstanding, India has continued to lag behind the East Asian economies. Empirical analysis of the changing structure of regional export baskets reveals that the East Asian economies have been successful in diversifying and upgrading their exports towards high growth-oriented, technology intensive and knowledge-based products in the manufacturing sector (Rajan and Sen, 2002). This is broadly consistent with the flying geese pattern (FGP). According to the FGP, economies are arranged in a descending order of their stages of industrialisation so that countries participate in the international division of labour at different stages in the product cycle in accordance with their comparative advantage. While the East Asian economies have been able to move rapidly from manufactured labour intensive commodities, India has largely been left out of the global division of labour, particularly with regard to the production of parts, components and accessories (PCAs) production. India's manufactured exports as a whole have remained somewhat stagnant when benchmarked against East Asia. India continues to rely on traditional labour intensive products, despite beginning the industrialisation process ahead of most of East Asia.

Japan has been a major player in expanding East Asian trade and upgrading the region's industrial structures via the infusion of FDI.

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<sup>1</sup> These countries have been chosen for comparison with India since, with the possible exception of Korea, they mostly constitute middle-income developing Asian countries whose development levels during the past decades were at comparable levels with that of India.

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Japanese FDI to East Asia really took off following the sharp appreciation of the yen after the Plaza Agreement of September 1985. Inflows essentially took place in three sequential but overlapping stages. First, investments were made in the newly industrialised economies (NIEs) like Korea, Hong Kong, Singapore and Taiwan during 1986–89. Second, labour-intensive Japanese investments began to be diverted to Southeast Asian countries (Malaysia, Indonesia and Thailand or MIT specifically) from 1988 to the early 1990s, attracted by the low wage levels and rapid growth of the region. Third, as the NIEs themselves moved to more capital and skill intensive stages of production, NIE firms also began using the MIT countries as export platforms for production of largely labour intensive PCAs of electronic products. Since the early 1990s, investments in China from Japan and other NIEs have grown dramatically.<sup>2</sup> In contrast, Japan has been an insignificant source of FDI to India. For instance, between 1998 and 2001, India accounted for a paltry 3 percent of Japan's total number of projects in Asia and less than 1 percent in value terms (data from Ministry of Finance, Japan).

Table 3 summarises trends in FDI *approved* and *actual* inflows in India. Note that the figures report the value of equity investments only, since FDI valuation in India is done at *equity investment* and not at *project cost* (in contrast to most other countries including those in East Asia). Equity investment is about one fifth to one third of total project cost.

Since the economic reforms in India in July 1991, when India attracted less than US\$0.5 billion worth of equity investments, approved FDI inflows in India increased annually to about US\$15 billion in 1997. It declined thereafter to about US\$8.6 billion by 2000. Overall, India approved nearly US\$72 billion worth of FDI since the post-reform period. However, the realisation of this approved FDI into actual disbursements has been quite slow; the average realisation ratio (i.e. actual inflows-to-approvals) was about 36 percent over the entire period.<sup>3</sup> Thus, the actual levels of FDI investments in the 1990s have averaged only about US\$2.5 to US\$3 billion annually.

<sup>2</sup> In fact, the Southeast Asian policy makers have expressed concerns about what they perceive as being a diversion of investments away from their countries to China. Their response has been to hasten the implementation of the regional free trade agreement (AFTA) as well as take early steps to create an ASEAN-China free trade agreement.

<sup>3</sup> One reason for this gap may be due to the type of investment projects involved. "Heavy duty" infrastructural, power and oil refinery-related projects tend by nature to involve much greater gestation periods between being approved and being actually realised.

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**Table 3: FDI inflows to India, 1991–2001**

	Total approved equity investments (US\$ billion)	Total actual equity investments (US\$ billion)	FDI realisation ratio (actual/approved FDI) (%)
1991	0.22	0.14	65.80
1992	1.49	0.26	17.37
1993	2.89	0.58	20.17
1994	4.52	1.05	23.18
1995	10.21	2.17	21.26
1996	10.51	3.02	28.74
1997	15.30	4.58	29.92
1998	7.80	3.38	43.29
1999	6.75	4.02	59.46
2000	8.61	4.50	52.22
2001*	4.09	2.16	52.81
Cumulative (1991–2001*)	72.40	25.86	35.72

\* Up to July 2001.

Source: Calculated from *SIA Newsletter*, various issues.

Inevitably, India's performance with regard to FDI pales when compared with its East Asian neighbours and with China in particular (Rajan and Sen, 2001). For instance, during 1992–98, cumulative FDI to India was US\$12 bn in equity, while that to China was twenty times as much (US\$240bn).<sup>4</sup> The rather listless response by foreign direct investors to the first decade of India's reforms is not inconsistent with the situation of China which experienced an acceleration in FDI flows only after 1986, despite the reforms being initiated in 1979 (Huang and Shirai, 1994). What is probably of more concern to Indian policy makers is the downward trend in the levels of FDI inflows in the last few years. Accordingly, a more proactive approach may be needed to encourage FDI, especially if it is to hope to come close to attaining the stated goal of attracting US\$ 10 billion in actual inflows annually (Blaxill and Maira, 2000 and Sachs et al., 2000). This effectively implies quadrupling the level of annual inflows that India currently receives. Recent initiatives such as leveraging on the world class infrastructural and supporting facilities offered by Singapore, and promoting the city state as a "gateway" to investing and doing business in India—

<sup>4</sup> A substantial amount of FDI in China is round-tripped via Hong Kong (Global Development Finance, 2002, Box 2.3).

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not unlike the role historically played by Hong Kong vis-à-vis Mainland China—are encouraging steps in the right direction.

### Information and communications technology: emerging potential and opportunities for leapfrogging

It is evident from the previous section that India has been significantly “out-competed” by its East Asian counterparts in gaining a global comparative advantage in manufacturing exports. Thus, India needs to find new growth niches in the service sector for sustaining global competitiveness.

The services sector in India has outperformed merchandise trade, especially over the post-reform period. Thus, while merchandise and services trade expanded at almost the same rate between 1980 and 1989 (9 percent), the average annual growth of services trade over the 1990–98 period was about 15 percent. India’s growth in services trade was nearly double that of merchandise trade during the 1992–98 sub-period itself. Growth in India’s services trade in the 1990s exceeded that of Indonesia and of Korea (Table 4). India’s share in Asia’s exports of commercial services (as defined by the WTO) increased from 3.5 to 5.8 percent between 1990 and 2000. India’s share in 2000 was higher than Malaysia, Indonesia and the Philippines, and about two-thirds of that of China and Korea (WTO, 2001, Table III.79). In 2000, India ranked 22nd in terms of its share in world exports of commercial services, with China and Korea being the only two East Asian economies ranked higher than India. For comparison, note that

**Table 4: Services, etc., value-added growth in India and East Asia, 1980–98 (% change)**

	1980–89	1990–98	1992–98	1980–98
China	12.73	8.53	9.39	10.74
India	6.54	7.06	7.74	6.78
Korea	7.86	5.90	5.11	6.93
Indonesia	7.55	4.90	3.56	6.30
Malaysia	5.60	7.45	6.66	6.48
Philippines	3.54	3.68	4.02	3.61

Source: World Bank (2000).

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**Table 5: Communications, computer, etc. [ICT] in India and East Asia, 1980–98 (% of service exports, BoP)**

	1980	1989	1990	1995	1997	1998
India	31.5	41.8	42.9	31.5	44.5	57.6
China	n.a	22.8	20.2	27.2	38.0	35.7
Korea	23.6	27.7	34.2	36.4	39.6	33.5
Indonesia	n.a	10.3	10.7	4.4	4.2	5.0
Malaysia	29.8	24.5	25.3	44.5	55.1	n.a
Philippines	63.6	77.6	77.6	84.3	82.0	76.4

Source: World Bank (2000)

during the same period, India ranked a lowly 31st in world merchandise exports and 26th in world merchandise imports. In contrast, the East Asian economies, save for the Philippines, were ranked far higher in merchandise trade than in services.<sup>5</sup>

Within the service sector, while the Information and Communication Technology (ICT) and related services were viewed as being nontradable just a few years ago, they have in fact been the main thrust of rapid expansion of services trade in India—accounting for nearly 58 percent of service exports and about 16 percent of total exports in 1998 (Table 5). Its share in India's services exports was almost double that in 1995. In comparison to the East Asian economies in 1997, before the regional financial crisis began, the share of ICT exports (to total services exports) in India was higher than that of China, Indonesia and Korea. During the crisis year of 1998, India had the second highest share in ICT service exports after the Philippines, and was the only country apart from Indonesia which experienced an increase in the share of ICT goods.

The ICT services sector comprises IT-related and enabled services, namely those involving trade in and use of computer software, hardware and the like, as well as services involving communications technology, namely the Internet, e-commerce and telecommunication sector. This category of services covers a wide range of activities, and primarily involves

<sup>5</sup> Specifically, China ranked 7th and 8th, Korea ranked 12th and 13th, and Malaysia ranked 18th in both world merchandise exports and imports, respectively. Even Indonesia was ranked 26th in world merchandise exports, higher than India.

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the extensive use of knowledge and information as a vital input in the factor of production—combining the latest developments in electronic and communications technology. Bajpai (2001) has noted that “(i)nspired by the success of Singapore, several developing countries consider IT as a unique opportunity to leapfrog whole stages of industrial development. Having missed the first two industrial revolutions, they are eager not to miss the third one—the making of the knowledge economy” (p.13).

The development of the ICT industry in India has been primarily attributable to the software and product services segments which posted an average revenue growth of about 50 to 60 percent annually during the 1990s; from a mere US\$20 million 10 years ago to US\$5.6 billion in 1999–2000. Growth of software development has been overwhelmingly market-driven as opposed to being government-led; government intervention has been minimal (“hands off”) and largely reactionary. Its expansion has been propelled by an increasing international demand for such skills (mainly from the US market) on the one hand, and India’s nurturing of a pool of skilled IT professionals, on the other.

The Indian software industry employs some 160,000 professionals and contributes to around 10 percent of India’s total merchandise exports. However, despite this rapid growth, India’s share in the total global software market is still miniscule, consequently suggesting there may be significant scope for future expansion. In view of this, the Indian government has identified the software industry as a major export and growth thrust area. A comparison of the major potential factors influencing the development of IT-enabled services reveals that India ranks favourably in comparison with some leading East Asian economies, with a clear advantage in terms of workforce availability and skills and also in terms of a cosmopolitan work culture (NASSCOM, 2001). Some segments of IT-enabling services (such as back-office operations, remote maintenance, medical transcription, call centers, content development and remote maintenance) have been important sources of employment generation in India.

### Summary and concluding remarks

India has made some important strides since the initiation of the reform program in 1991, and has been one of the fastest growing economies in the world. Given that the liberalisation program in India has been evolution-

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ary (with inevitable hiccups and backtracking in the interim) rather than revolutionary, even a decade may offer too few degrees of freedom to pass definitive judgment on the longer-term prospects of the Indian economy. Nonetheless, considering that India faced virtual bankruptcy in mid 1991, its economic performance since then has been laudable and rather under-appreciated.

On the positive side, all indicators reveal that the reduction of the anti-export bias has allowed the Indian economy to attain a higher degree of integration with the global economy in the 1990s compared with previous decades. On the negative side, India remains highly inward looking in comparison with China and its other East Asian neighbours which embraced the multilateral trading system and had laid out the welcome mat for FDI much earlier (in the mid to late 1970s and 1980s). Accordingly, while the East Asian economies have been able to move rapidly from manufactured labour intensive commodities, India has largely been left out of the global division of labour, particularly with regard to parts and components (PCAs) production. India's manufactured exports as a whole have remained stagnant when benchmarked against East Asia. It continues to rely on traditional labour intensive products despite beginning the industrialisation process ahead of most of East Asia

India has, however, fared much better in the area of services trade, particularly in new and dynamic sectors like information and communication technology (ICT). The ICT sector in general has brought substantive advantages to India over and above direct employment creation and being an additional source of export earnings. As Miller (2001) has noted:

The fact that India is demonstrably competitive internationally in the production of sophisticated software brings other advantages to the country. Indian technological sophistication, though still narrowly defined, has begun to alter international perception of the country. Instead of viewing India as a country burdened by decades of heavy-handed government regulation of the economy, foreigners now view the country somewhat more favourably, though not yet as a country where future growth will approximate that of China and several of the Southeast Asian countries (p.21).

The ICT sector in India, while being a very promising growth niche, is still at a very nascent stage of development. While the software industry is diversifying into new areas with strong growth potential like Applications

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Service Providers (ASP), e-commerce and related applications, the hardware component industry is yet to take off.<sup>6</sup>

In acknowledgement of the strategic importance of IT for the country, the central government has a goal of making India a global economic power in IT by 2008, and has established a National Task Force to achieve this end. Among the major initiatives, as part of the 108 recommendations made by the National IT Taskforce, the Indian government is providing a strong thrust to facilitate supportive infrastructure for proliferation of IT Enabled Services throughout the country and developing strategies for wooing large companies to set up IT Enabled Service units in their state. Many State governments (like Andhra Pradesh, Karnataka and Tamil Nadu) have started providing a special drive towards IT Enabled Services. Such initiatives are especially important in view of the growing competition in the low-value added segment of the software market (i.e. in customised software and IT-enabled services) from the Philippines and China (Kumar, 2001). India needs to quickly rise up the value-chain and move into software production and development, for which several critical measures—in the areas of greater emphasis on Research and Development (R&D) and product development, acquisition of global marketing channels/brands, and industrial restructuring—are required.

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<sup>6</sup> The development of the hardware sector has been held back by long-standing and severe bottlenecks in infrastructure and supporting facilities (discussed in Brahmbhatt et al., 1996), and a rather unattractive tax regime. The East Asian economies including China have outperformed India in this area. Lal (2001) has suggested that "the hardware sector in thoroughly demoralised in India...India needs a positive agenda rather than merely adopting a *laissez faire* policy...in IT manufacturing" (p.116).

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