International Journal of Advanced Research and Development
ISSN: 2455-4030
Impact Factor: RJIF 5.24
www.advancedjournal.com
Volume 3; Issue 1; January 2018; Page No. 104-108

Impact of globalisation on India's external sector

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Abstract
India depends on the foreign sector for its goods and services, factors of production and livelihood for a considerable portion of the population. Since the starting of 2012, there has been a deceleration in the global economy as most of European economies have been in recession or very close to it. Consequently, unemployment rates have been at record highs leading to very low purchasing power that has badly reduced the demand for Indian goods abroad. Thereby, there has been a sharp fall in exports volume of India. Alternatively, falling commodity prices in European countries owing to recession has been resulted in increase in Indian imports. This has given rise to imbalance between payments and receipts of India vis-à-vis the rest of the world leading to high rate of persistence Current Account Deficit (CAD) and domestic currency depreciation to the record highest extent. On the backdrop of crisis in European economies after globalization, this paper highlights consequential effects on vulnerable Indian economy in the form of CAD and rupee depreciation with facts and figures.

Keywords: global crisis, European economies, current account deficit, currency depreciation

Introduction

The world economy came across a prominent downturn starting in the third quarter of 2008 followed by economic slowdown since the beginning of 2012 after several years of impressive growth. The world economy had the benefit of a period of outstanding growth and stability until the occurrence of the global crisis in 2008. Average growth of the world economy during 2002-07 surpassed that of the 1990s by almost one-half. Since then up till now, the world economy is struggling to test the taste of a reasonable growth rate owing to global crisis of 2008 coupled with deceleration of European economies since 2012. The U.S. was beset by weak economic growth, ballooning debt and stubbornly high unemployment but the collapse of the housing bubble that spurred the 2008-2009 global financial crisis was more a consequence than a cause of what is wrong. The real culprit was and remains poor policymaking in the areas of taxation, finance and economics, which helped bring on the crisis by encouraging Americans to engage in counterproductive behaviour.

The euro area economy slipped back into recession in the third quarter of 2012 as the GDP shrank by 0.1 per cent following a contraction of 0.2 per cent in the previous quarter. Spillovers from advanced economies and domestic constraints have affected economic activity in emerging and developing economies as well.

With heavy population pressure and population that is exceedingly trapped in the clutch of demonstration effect, Indian economy has been highly dependence on international trade. As domestic production does not suffice to meet the consumption demand of the growing population, dependence on imported products has been must and to meet the expenses for imported products, generation of foreign exchange in the form of exports has been the best way out. Accordingly, the volume of foreign trade has been growing tremendously in recent years. In fact, there has been complete dependence on foreign trade for India's growth and development. While, owing to heavy population pressure and paucity of capital, Indian economy seeks for labour intensive technology of production, for higher rate of economic growth, adoption of capital intensive technique has been essential. It is the international exposure only that enables India to adopt capital intensive technology in many sectors in spite of lot many odds. Not only the need of the required technology has been fulfilled by the foreign sector, residual manpower owing to adoption of technology has also been accommodated by the foreign sector. Thus India depends on the foreign sector for its goods and services, factors of production and livelihood for a considerable portion of the population. In such a situation, if anything goes wrong with the foreign sector, India is bound to be impacted in many fronts. In fact, India is vulnerable to evils that may crop up in foreign countries.

Although India has taken steps to diversify exports to new and emerging markets of Africa and Latin America, the traditional destinations of Europe, the US and Japan still constitute about 60 per cent of India's exports. Even if a recession is turned aside in Europe, the sluggish growth would have insinuations for India. The European Union accounted for nearly $47 billion of India's total exports of $254 billion last fiscal, making it a larger destination than North America. Exporters are worried that debt crisis will hit demand and lead to payment problem. But, the Federation of Indian Export Organisations said that European crisis will not have severe impact on India's exports in the long run because of country's diversified shipments to new trade destinations. The UN report also pointed to a downside risk to India's economic growth in 2013 on account of problems in Europe and the USA.

Global Crisis inherited from European Union's dire fiscal Straits

European countries are facing the most awful crisis now since the Second World War. Monetary alliance of European countries has led to rescue expectations, which in turn resulted in soft budget constraints and over-borrowing. Portugal, Ireland, Italy, Greece, and Spain (the so called PIIGS countries) are hit hardest by the recent European sovereign debt crises.

But why would the PIIGS and more generally any European Economic and Monetary Union (EMU) country borrow so much as to risk default? All EMU governments should have had an incentive to run sound fiscal policies for their own good. Especially because monetary policy could not be used anymore to deal with the consequences of fiscal profligacy after the introduction of the Euro, implementing sustainable fiscal policies should have been their preferred strategy. There is, however, one circumstance under which it would have been rational for an EMU country to deliberately accumulate unsustainable levels of debt: if the country in question had expected a bailout once a debt crisis struck. As shown in the empirical literature on fiscal federalism, such bailout expectations can upshot in soft budget constraints and over-borrowing (Baskaran, 2011) [1].

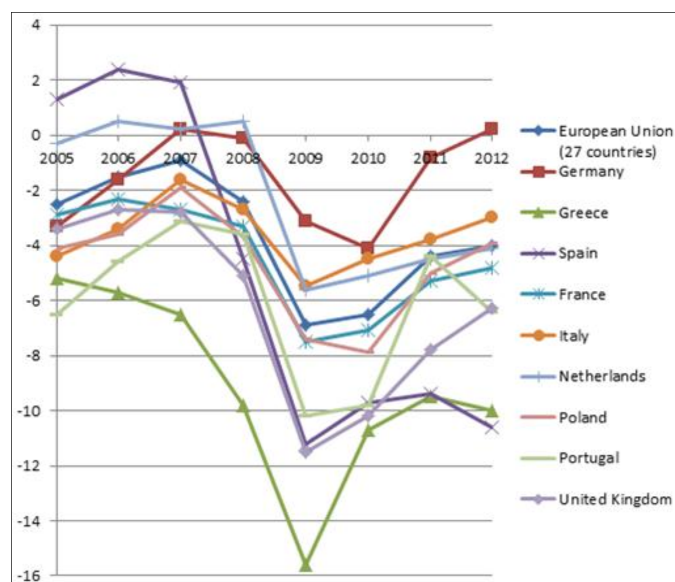
The primary economic reason for monetary unification was the hope that it would reduce harmful policy spillovers and competitive devaluations. In addition, they argued that countries with traditionally high inflation rates could reduce inflation by joining a currency union with low-inflation countries, in particular with Germany.

But while there were such economic arguments for unification, for voters in economically strong and macro-economically stable countries political reasons were probably more incisive for the acceptance of a common currency. In particular, it was argued that monetary unification is a necessary predecessor for political confederacy, which would ensure Europe lasting peace and more political cuff vis-a-vis non-European countries. The critics of monetary integration focused on its economic perils and questioned that monetary integration would reduce macroeconomic fluctuations. They pointed out that dis-agreements between the European monetary authority and national fiscal policy makers were likely to lead to erratic macroeconomic developments. To prop up this supposition, they argued that the European Union is not an optimal currency area: because it would consist of countries with different economic structures and therefore a single monetary policy would be ill-suited to retort to asymmetric jolts sufficiently (Pappa and Vassilatos, 2007) [3].

Moreover, the critics were worried that as a result of the commencement of a common currency, the EU would entrust into a "transfer union", reallocating resources from rich to poor member states. To address this concern, European policy makers decided that potential Euro member countries had to accomplish a set of convergence criteria, spelled out in the Maastricht treaty. In particular, countries were required to have a debt to GDP ratio of below 60% and consecutive deficits of not above 3% of GDP during the run-up to the Euro. In addition, a stipulation that was commonly interpreted as a no-bail out clause was included in the treaty.

The PIIGS countries expected that they would get either a monetary or a fiscal bailout once levels of debt became unsustainable because the wealthier countries would have already committed too much to the European Project. This expectation was bolstered once Germany and France themselves breached the deficit criteria without facing real consequences.

The average level of deficit as a percentage of GDP in EU countries in 2012 is much lower (4 percent) than it was in 2009 (6.9 percent).

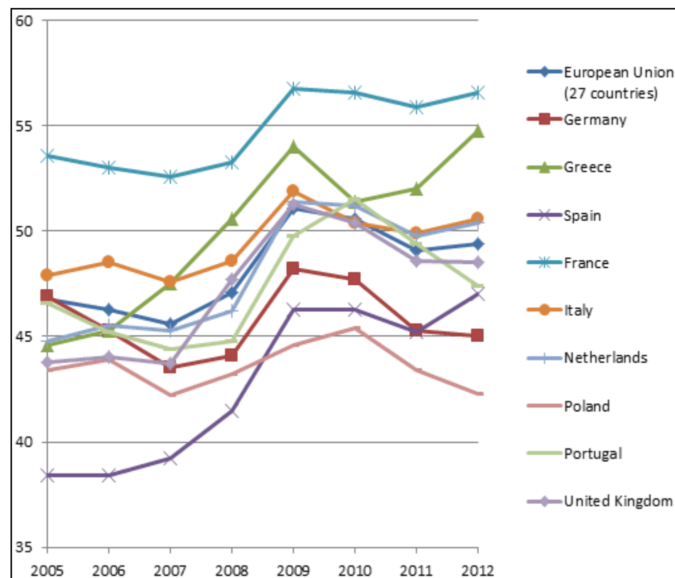


***Source*:** Eurostat, Government deficit/surplus, debt and associated data.

Fig 1: General government deficit as a percentage of GDP

It should be noticeable that there is no direct relationship between dipping the size of the deficit and reducing the size of government, the latter being a key factor to consider. A budget deficit can be reduced either by minimizing spending or by escalating revenue. It can also be reduced if spending is cut a lot but taxes are cut only a little. It can be reduced even as spending increases if revenues increase even faster.

In practice, "austerity" can thus cover all kinds of situations with differing economic impacts. The term can apply just as well to growth as to reduction in the size of government. It seems to be universally taken for granted in this debate that austerity measures adopted in Europe have meant drastic spending cuts, coupled with some tax increases, the net effect being a downsizing of government. But is this really the case? As Figure 2 shows, there has only been a slight decrease of 1.7 percentage points in government spending as a proportion of GDP in the Union as a whole over the past three years. Moreover, the proportion is still 4 percentage points higher in 2012 than before the crisis started, 49.4 percent compared to 45.6 percent in 2007. Among the major countries included in this figure, only in Poland have expenditures gone back to where they were in 2007.



Source: Eurostat, Government revenue, expenditure and main aggregates.

Fig 2: Total general government expenditure as a percentage of GDP

However, there is basis to wonder if these numbers have been buckled by the periods of negative economic growth that have hit the continent. Expenditures may have come down in absolute terms, but they would still be higher as a proportion of GDP if the economy had contracted even more. So, let's look at expenditures in nominal terms. Governments in almost all European Union countries are therefore as large as they were when the crisis started in 2007 or even larger today.

If we define austerity as the measures taken to reduce budget deficits, then in that sense austerity is indeed responsible for the crisis. If, however, we define it more properly as policies bringing about a reduction in the size of government, then these policies cannot be held responsible for the crisis in Europe because they were never applied.

The European sovereign debt crisis has also become increasingly a social crisis for the most affected countries, with Greece and Spain having the highest unemployment rates in the currency area. Spain's unemployment was 26.9 percent in May 2013, while Greece's rate in March was 26.8 percent.

India's subdued exports performance, which began in H2 of 2011-12, showed further deterioration during 2012-13 so far. Since the outlook for global growth remains weak, it is unlikely that exports will reach even the previous year's level. Commodity-wise data show that growth in exports of engineering goods, petroleum products, textile products, gems & jewellery and chemicals & related products was severely affected because demand conditions in key markets such as the US and Europe continued to remain sluggish.

Global Crisis and Indian Balance of Payments (Bop)

The structure of Indian Balance of Payments passes through distortion phase owing to global crisis. Exports during May, 2013 were valued at US $ 24505.66 million (Rs. 134807.62 crore) which was 1.11 per cent lower in Dollar terms (0.13 per cent lower in Rupee terms) than the level of US $ 24779.72 million (Rs. 134983.82 crore) during May, 2012. Cumulative value of exports for the period April-May 2013 -14 was US $ 48670.03 million (Rs. 266203.05 crore) as against US $ 48568.66 million (Rs. 258239.33 crore) registering a growth of 0.21 per cent in Dollar terms and growth of 3.08 per cent in Rupee terms over the same period last year. Imports during May, 2013 were valued at US $ 44649.26 million (Rs.245619.14 crore) representing a growth of 6.99 per cent in Dollar terms and 8.04 per cent in Rupee terms over the level of imports valued at US $ 41733.45 million (Rs. 227336.72 crore) in May, 2012. Cumulative value of imports for the period April-May, 2013-14 was US $ 86600.99 million (Rs. 473734.59 crore) as against US $ 79540.94 million (Rs. 423225.26 crore) registering a growth of 8.88 per cent in Dollar terms and growth of 11.93 per cent in Rupee terms over the same period last year.

With a view to boost exports, the government announced several measures in foreign trade policy (FTP) including extension of the popular EPCG scheme to all sectors and sops for Special Economic Zones (SEZs). Exports had entered positive zone after a gap of eight months in January 2013 when it recorded a growth of 0.82 per cent. Export performance has started picking up. For March, the export performance has picked by a slightly robust figure as compared to the previous two months. During 2012-13, imports grew by 0.44 per cent to 491.48 billion dollars, leaving a trade deficit of 182.1 billion dollars from 183.3 billion dollars in 2011-12. Oil imports in March 2013 declined by 16.56 per cent to 13.32 billion dollars. During the previous fiscal, the imports however grew by 9.22 per cent to 169.25 billion dollars from 154.96 billion dollars in 2011-12. Non-oil imports in March increased by 5.41 per cent to 27.83 billion dollars but during 2012-13, it dipped 3.62 per cent to 322.23 billion dollars. While announcing sops for exporters, commerce and industry minister Anand Sharma said in 2012-13, India's exports to Asia, Africa and Latin America touched 195.27 billion dollars, accounting for 65 per cent of the total export basket.

The balance of payments, however, is under strain with current account deficit (CAD) widening to 4.6 per cent of GDP in the first half of 2012-13, after touching 4.2 per cent in 2011-12. The CAD is being financed by capital flows and not by running down reserves. However, a sizeable share of capital is in the nature of Foreign Institutional Investors (FIIs) investment that could moderate or even reverse if investors switch to risk-off mode. The balance of payments position therefore is more vulnerable, which has been reflected in high rupee volatility.

India's BoP was under stress during 2011-12, as the trade and current account deficit widened. Though capital inflows increased, it fell short of fully financing current account deficit, resulting in drawdown of foreign exchange reserves. The trade deficit increased to US$ 189.8 billion (10.2 per cent of GDP) in 2011-12 as compared to US$ 127.3 billion (7.4 per cent of GDP) during 2010-11. This increase of 49.1 per cent in trade deficit in 2011-12 was primarily on account of higher increase in imports relative to exports. Net invisible balances showed significant improvement, registering 40.7 per cent increase from US$ 79.3 billion in 2010-11 to US$ 111.6 billion during 2011-12. Net invisible balance as per cent of GDP improved to 6.0 per cent in 2011-12 from 4.6 per cent in 2010-11. The current account deficit widened to US$ 78.2

billion (4.2 per cent of GDP) as compared with US$ 48.1 billion (2.8 per cent of GDP) in 2010-11. Net capital inflows were higher at US$ 67.8 billion (3.6 per cent of GDP) in 2011-12 as compared to US$ 63.7 billion (3.7 per cent of GDP) in 2010-11, mainly due to higher FDI inflows and NRI deposits. As the capital account surplus fell short of financing current account deficit, there was a drawdown of reserves (on BoP basis) to the extent of US$ 12.8 billion during 2011-12 as against an accretion of US$ 13.1 billion in 2010-11.

In the first Half (H1 - April-September 2012) of 2012-13, there was a steep decline in exports to US$ 146.5 billion, registering a 7.4 per cent decline over US$ 158.2 billion in H1 of 2011-12. Commodity wise data show that growth in exports of engineering goods, petroleum products, textile products, gems & jewellery and chemical & related products were severely affected as the demand conditions in key markets like the US and Europe continued to remain sluggish. During H1 of 2012-13, EU accounted for nearly 27 per cent of the total decline in merchandise exports, followed by Singapore (19 per cent), China (13 per cent) and Indonesia (6 per cent). Lower growth in export oriented Asian economies caused by setbacks to the global recovery has clearly weighed on India's external demand from these economies. Like exports, there was decline of 4.2 per cent in imports to US$ 237.2 billion in H1 of 2012-13 from US$ 247.7 billion during the corresponding period in previous year. The steep fall in exports than that in imports was responsible for widening of trade deficit to US$ 90.7 billion (10.8 per cent of GDP) in H1 of 2012-13 vis-à-vis US$ 89.5 billion (9.9 per cent of GDP) in H1 of 2011-12.

Capital and Financial Account during H1 of 2012-13

Both gross inflows of US$ 219.5 billion and outflows of US$ 179.5 billion under the financial account were lower in H1 of 2012-13 as compared with gross inflow of US$ 246.4 billion and outflow of US$ 202.9 billion in the same period a year ago. In net terms also, financial inflows declined to US$ 40.0 billion in H1 of 2012-13 as against US$ 43.5 billion in H1 of 2011-12. As regards the pattern of capital inflows during H1 of 2012-13, there has been a mixed trend. Inward FDI to India at US$ 16.2 billion during H1 of 2012-13 decreased by 26.0 per cent compared to US$ 21.9 billion in H1 of 2011-12. Outward FDI by India was US$ 3.4 billion in April-September 2012 as against the US$ 6.1 billion in April-September 2011. The net FDI (inward minus outward) to India was US$ 12.8 billion during first half of 2012-13 vis-a-vis US$ 15.7 billion during the corresponding period of previous year. However, recent measures taken by Government regarding liberalisation of FDI limits are likely to improve investment sentiment and to boost FDI flows into the Indian economy. Scope for further liberalization of FDI norms however remains.

Net portfolio flows including FIIs showed a quantum jump to US$ 5.8 billion during H1 of 2012-13 as against US$ 1.3 billion in H1 of 2011-12. Among debt creating flows, NRI deposits remained robust at US$ 9.4 billion in H1 of 2012-13 (US$ 3.9 billion in H1 of 2011-12) but net flows under ECBs declined sharply by about 80.0 per cent to US$ 1.7 billion during H1 of 2012-13 from US$ 8.4 billion in H1 of 2011-12. However, unlike in H1 of 2011-12, net flows under trade credit showed an increase of nearly 60 per cent to US$ 9.5 billion during April-September 2012 as against US$ 5.9 billion during the corresponding period of 2011-12. Net accretion to reserves (on a BoP basis) during H1 of 2012-13 at 0.4 billion was substantially lower as compared to US$ 5.7 billion in H1 of previous year.

As per the latest available information on capital inflows, FDI flows to India stood at US$ 22.2 billion during April-December 2012, which is 22.1 per cent lower than US$ 28.5 billion during April-December 2011. Up to December 2012, net FII flows amounted to at US$ 16.0 billion (US$ 2.7 billion during the corresponding period of 2011-12). FII flows in recent months witnessed improvement, reflecting the impact of various reform measures announced by the Government.

India's current account deficit (CAD) increased further in Q2 of 2012-13 mainly due to the worsening trade deficit, decelerated growth in net export of services and higher outflows under primary income. The CAD–GDP ratio at 5.4 per cent is not only unsustainable, but is also the highest-ever peak level. Early indications are that in Q3 of 2012- 13, CAD as a percentage of GDP may increase further from this peak. Subdued growth conditions in major advanced economies seem to have impacted growth in India's export of software services in recent quarters. However, results of major IT firms for Q3 of 2012-13 suggest some improvement in their dollar revenues. Even though global IT spending is projected to increase by 4.2 per cent in 2013. The trade deficit for April - May, 2013-14 was estimated at US $ 37930.96 million which was higher than the deficit of US $ 30972.28 million during April - May, 2012-13.

Status of Indian Currency on the backdrop of Global Crisis

India maintains to be one of the leading holders of foreign exchange reserves. Country-wise details of foreign exchange reserves divulge that India is the eighth biggest foreign exchange reserves holder in the world, after China, Japan, Russia, Switzerland, Brazil, Republic of Korea and China P R Hong Kong at end-December 2012. Indian foreign exchange reserves has been affected badly because inflows has been checked owing to deceleration in the EU and the US while depreciated Indian rupee has caused considerable outflows for the imports. Thus India continues to record a current account deficit of around 4.3%, depleting its Forex reserves in the bargain and thus depreciating the rupee.

The exchange rate policy is guided by the broad principles of careful monitoring and management of exchange rates with flexibility, while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly manner. Subject to this predominant objective, intervention by the RBI in the foreign exchange market is guided by the objectives of reducing excess volatility, preventing the emergence of destabilizing speculative activities, maintaining adequate level of reserves, and developing an orderly foreign exchange market.

The movement of the exchange rate in 2011-12 indicates that the average monthly exchange rate of rupee against the US dollar depreciated by 10.6 per cent from Rs. 44.97 per US dollar in March 2011 to Rs. 50.32 per US dollar in March 2012. Similarly, on point-to-point basis, the average exchange rate of rupee (average of buying and selling rate of FEDAI)

depreciated by 12.7 per cent from Rs. 44.65 per US dollar on 31 March 2011 to Rs. 51.16 per US dollar on March 30, 2012. However, depreciation of Indian rupee reached at its zenith in the month of July, 2013 crossing Rs. 61 point for one USA Dollar.

Conclusion

In order to convert weaknesses, in the form of dependence on EU for its exportables, into opportunities, India has to explore the possibilities of exporting the goods and services to other countries which are away from economic slowdown owing to debt crisis or recession. Accordingly, the Indian government has introduced focused market schemes (special incentives) to diversify exports. So the crisis in Europe should be seen as an opening for India to break into the markets where they export. Latin America and West Asia are the top growing export markets for India. China, including Hong Kong, accounts for 12 per cent of India's export and is the largest export market for engineering goods. The BRICS region, as a whole, now accounts for one-sixth of India's merchandise exports. Among Asian Tigers, Taiwan and South Korea are key export markets to fall back on in times of crisis. In Europe, a non-EU fast growing country, Turkey, has become an important export destination for India and witnessed an export growth rate of 79.1 per cent in 2010-11. The acceptance of Russia into the WTO fold will further open up this high-potential market for Indian businesses. Among key export items with more than 2 per cent share in India's overall exports, only a few items such as organic chemicals and pharmaceuticals, readymade garments, iron & steel, machinery & mechanical appliances and electrical machinery & equipment have high (more than 30 per cent share in India's export of an item) exposure to Europe and the US, taken together. Again, only two product categories — readymade garments and electrical machinery & equipment — have very high exposure to Europe. Given the slow progress of WTO talks, India can use bilateral routes under PTAs/FTAs to secure improved market access for heavily protected textiles and clothing items.

Private final consumption expenditure of India accounts for roughly 60 per cent of India's GDP compared with China's 35 per cent or so. Thus, India's dependence on the external sector is still not very high though it has increased over the years manifold. India is primarily a consumption story and with rising income and expanding middle-class it will remain so. Increasing income of rural population will further generate demand for industrial products and keep the economic wheel moving. Even though India has reduced its dependence on Europe and the US by diversifying towards non-traditional markets in emerging economies, challenges to its economic performance remain.

- A deteriorated sovereign debt crisis in the Euro Zone and growing risk aversion on the part of FIIs may keep net forex inflows low for a far longer period.
- With the RBI's limited maneuverability in the forex market, rupee will remain under pressure. This may affect the cost-competitiveness of import-dependent manufacturing industries already facing a high cost of borrowing, such as copper smelters or petroleum refineries.
- India's uninspiring performance on the policy front — be it land acquisition, speedy environmental clearance, allowing FDI in specific sectors or checking fiscal deficit and inflation or tackling corruption — is making investors, domestic and foreign, nervous.

In spite of weakening Indian Rupee, the exports volume of India has not been turned to be favourable as the foreign customers of Indian exports are in recessionary phase. Instead, owing to recession in European countries and the US, the highly depreciated Indian Rupee has failed to check the import volume. This is the high time for India to look into the matter intuitively and take necessary steps to save the depreciated Indian rupee which has been a toll over the import-dependent manufacturing industries.

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