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Openness and Growth of the Indian Economy: An Empirical Analysis



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In commemoration of Jawaharlal Nehru Birth Centenary (1889 - 1989), Export-Import Bank of India instituted the International Economic Development Research Annual (IEDRA) Award in 1989. The objective of the award is to promote research in international economics, trade and development and related financing, by Indian nationals at universities and academic institutions in India and abroad. The study titled 'Openness and Growth of the Indian Economy: An Empirical Analysis' is based on the IEDRA Award 2010 winning thesis by Dr. Narayan Chandra Pradhan, Research Officer, Reserve Bank of India, Mumbai.

Introduction

The openness of an economy broadly refers to the increasing integration of a country with the global economy through trade and financial flows. The trade channel is considered as one of the traditional modes, while mobility of capital has provided a new dimension that relatively dominates over conventional trade channel. Since 1980s, interdependence among nation-states has increased significantly in respect of trade to Gross Domestic Product (GDP) ratio. The growth of world merchandise trade today has surpassed the growth of world GDP leading to even doubling of the trade-to-GDP ratios for some emerging economies between 1980 and 2008. This has emanated mostly from the increasing openness of the world's trade and financial markets and ongoing globalization of labour migration.

The structure of Indian economy too has undergone a considerable change since mid-1991. International trade and capital

flows have gained increasing importance. The services sector has become a major driver of the economy with GDP share of more than 50 percent. The country has become an important hub for export of Information and Technology enabled services (ITES). The share of merchandise trade to GDP has also witnessed an increase from 7.2 percent in 1980-81 to 13.3 percent in 1990-91 and further to 38.9 percent in 2008-09. The rapid growth of the economy from 2003-04 to 2007-08 also made India an attractive destination for capital inflows and net capital inflows. Foreign portfolio investment added buoyancy to the Indian capital markets and Indian corporate began aggressive acquisition spree overseas, which was reflected in the high volume of outbound direct investment flows during 2007-2009. The year 2008-09 was, however, marked by adverse developments in the external sector of the Indian economy, particularly during the second half of the year, reflecting the impact of global financial crisis.

Openness and Growth in World Economy

The world economy has witnessed an age of unprecedented globalization since the 1980s. International trade and services along with capital flows have been liberalized and allowed to grow in many developing countries. There is substantial evidence from countries of different sizes and different regions that have benefited from the global process of openness in the form of access to wider variety of goods and services, lower prices, more and better paying jobs, improved health and higher overall living standards.

In late 1980s, many developing countries, including India, started dismantling their barriers to international trade, as a result of poor economic performance under protectionist policies and various economic crises. In the 1990s, many former Eastern bloc countries integrated into the global trading system and developing Asia - one of the most closed regions to trade earlier - progressively

dismantled barriers to trade. Overall, while the average tariff rate applied by developing countries is higher than that applied by advanced countries, it has declined significantly over the years, especially, in the aftermath of the formation of World Trade Organization (WTO) in January 1995.

The world financial markets have experienced a dramatic increase in openness in recent years. Global capital flows fluctuated between 2 and 6 percent of world GDP during the period 1980–1995 and since then has been rising. In 2008 they aggregated to US \$ 7.9 trillion, more than tripling since 1995. Though the most rapid increase has been experienced by advanced economies, emerging markets and developing countries have also become more financially integrated. As countries have strengthened their capital markets, they have attracted more investment capital, which enables a broader entrepreneurial class to develop, facilitate a more efficient allocation of capital, encourage international risk sharing, and foster economic growth.

The Study

The nature of relationship between openness and economic growth has been one of the most debated topics in recent past. The research question addressed in the study is “whether openness has an impact on growth, and if so, then in what direction?” This question is important because the determination of causal pattern between export and growth has important implications for policy makers’ decision about the appropriate growth strategies and policies to adopt. The study adopts an eclectic approach drawing from the theoretical and empirical literature as well as economic history of multilateral institutions. The study examines whether the trade policy reforms have had any role to play in India’s recent economic growth. The assessments of impact of openness is not only confined to merchandise trade, but also to trade in services, labour migration and its financial impacts, as well as impact

of capital flows on growth. The study also discusses the role of international institutions in promoting openness and in fostering process of growth in world economy.

In recognition of the growing importance of external openness in Indian economy, the focus is assigned on changing trade policy regimes of India; trade performance in the global context during the liberalization period; and changing trade patterns. Services exports have opened up new opportunities for India since the liberalization process started and seen a structural shift starting from 2003-04 driven by the emergence of new avenues – exports of software services and business services that augur well for the services led growth.

An overview of literature on the nexus between openness and growth reveals many aspects. The theories of trade discussed are those based on certain assumptions and tried to explain: (i) how and why different countries may gain from trade; and (ii) pattern of trade specialisation, i.e., why certain countries export particular goods and import others. The review of trade theories starting from the Mercantilism and ending with New Trade models have focused on three dimensions, viz. (i). export as a leading sector; (ii) export as a balancing sector; and, (iii) export-linked import liberalization in both developed and developing countries.

Role of Multilateral International Institutions

More than sixty years have passed since the formation of Bretton Woods institutions – the International Monetary Fund (IMF), World Bank and GATT/WTO. Over these years, the world economy has changed considerably not only in the realm of economics but also in the sphere of public policy. International institutions have played major role in shaping world economic order and help reviving the openness of emerging economies. The IMF, World Bank,

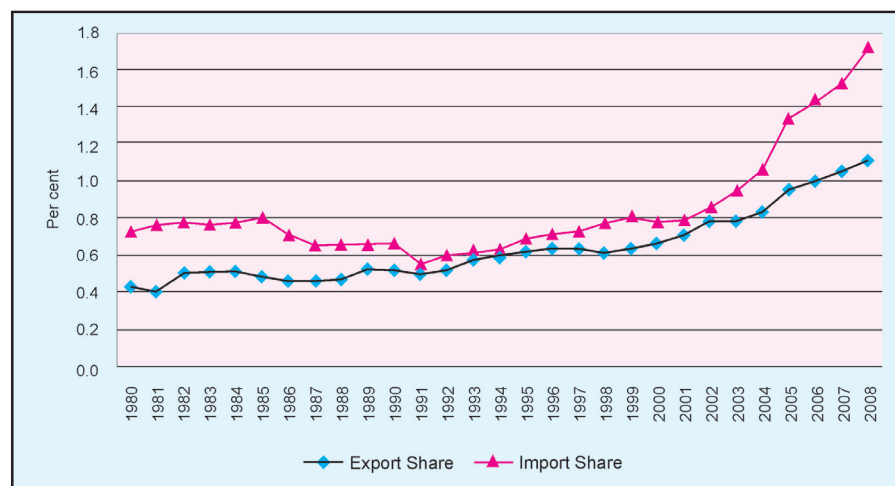
and the WTO share the common goal of facilitating/promoting the balanced expansion of trade in goods and services. Responsibilities for trade issues are divided among the three institutions. The WTO focuses on rules for multilateral trade liberalization and transparency; the IMF on overall macroeconomic policy framework and balance of payments disequilibria; and the World Bank on long-term growth, development and sectoral trade issues. The ILO’s role has been to ensure that the human face of labour is not lost in implementing the competitive agenda of trade openness and growth. It is envisaged to ensure labour standards and setting minimum standards of basic labour rights. Each of the three institutions has a mandate for cooperation.

India’s Trade Openness, Trade Policy and Growth

Beginning mid-1991, the Government of India introduced a series of reforms to liberalize and globalize the Indian economy, i.e., adapting to the path of openness. Reforms in the external sector were intended to integrate the Indian economy with rest of the world. Reform of trade and exchange rate policy was a critical element in process of structural reform. Since the initiation of economic reforms, India’s outward orientation has increased considerably. The major trade policy changes in the post-1991 period included simplification of procedures, removal of quantitative restrictions, and substantial reduction in the tariff rates. However, India’s approach to openness has been cautious, contingent on achieving certain pre-conditions to ensure an orderly process of liberalization and ensuring macroeconomic stability. This approach has been vindicated in the recent years with the growing incidence of financial crises in the world economy. Over and above all, the policy regime in India with regard to liberalization of the external sector has witnessed perceptible change.

In 1950, India accounted for about 1.8

Chart : India's Share of Global Merchandise Exports and Imports



Source: Directorate General of Commercial Intelligence and Statistics (DGCI&S), GOI

per cent of world trade. After gradually declining to 0.5 percent in 1991, it marginally improved to 0.6 percent in 1994. Subsequently, the decline in India's share in world trade has not only been arrested but reversed. Since 1991, India's share in world exports as well as imports have witnessed a rising trend (Chart). The Foreign Trade Policy (FTP), 2004-09 had set an ambitious task of achieving 1.5 per cent share in the world trade by the year 2009. Recently announced FTP 2009-14 also set the long-term policy objective to double India's share in global trade by 2020.

Openness and Services Trade in India

The growing importance of services sector in national output has been accompanied by an expansion of commercial services in world exports. The dynamic effects of liberalizing trade in services are increasingly being assessed in the context of growth. Spillovers of technology or skills embodied in service flows increase productivity of national factors of production and hence help to increase GDP.

India's trade in services under balance of payments (BoP) comprises non-factor services categorized under (i) travel, (ii) transportation, (iii) insurance,

(iv) 'Government services not included elsewhere' (GNIE), and (v) miscellaneous services. Under miscellaneous services, four major categories are software services, business services, financial services, and communication services. An important feature of services exports of India has been a structural shift since 2003-04, driven by the emergence of new avenues of services exports attributed to a rapid expansion in international trade and investment facilitated by an increased liberalization and the use of information technology enabled services (ITES). Services exports doubled from US\$ 26.9 billion in 2003-04 to US\$ 57.7 billion in 2005-06 and further to US\$ 101.2 billion in 2008-09. India's share in world exports of services has doubled to 2.7 percent between 2003 and 2008. Reflecting this positive development in terms of the comparative advantage and the continued buoyancy of India's services exports, India ranked at 9th position in terms of its market share in the world services exports during 2008.

Since 1991, India has carried out a substantial liberalization of trade in services along with freeing up of foreign investment. Traditionally, services sectors have been subject to heavy government intervention. Public sector presence has been conspicuous in the

key sectors of insurance, banking, and telecommunications. Nevertheless, considerable progress has been made toward opening the door wider to private sector participation, including foreign investors.

Services have shown relative resilience vis-à-vis other components of India's balance of payments in the face of global economic slowdown, with net services surplus expanding from US\$ 37.6 billion during 2007-08 to US\$ 49.8 billion during 2008-09, led primarily by software services exports. India's services receipts are dominated by travel earnings, software and business services, reflecting a strong international tourist interest in India, rising importance of India's high skilled workers and comparative advantage in exports of technology enabled services.

Migration and Financial Flows in Indian Economy

In recent years, the world has witnessed migration of labour as a major feature despite the restrictive immigration laws, owing to the differences in demographic pressure and income levels among countries. At the same time, spread of education and communication are also facilitating the progress of labour openness or migration from developing countries to the developed ones. Though international labour movements are influenced by forces of supply and demand, it is constrained by non-economic factors, such as, explicit immigration laws or implicit consular practices.

Inflows from overseas Indians are mainly in the form of: (i) inward remittance towards family maintenance; and (ii) deposits in the Non-Resident Indian (NRI) deposits schemes with the banks in India.

The workers' remittances are linked to labour migration. These remittances are recognized as a relatively reliable source of external finance as compared with

capital inflows. Among the components, local withdrawals from NRI deposits showed relative stability. In recent years, there is an upsurge in workers' remittances to developing countries. The macroeconomic impact of remittance flows is more important in a situation where the departure of migrants does not reduce domestic output and remittances increase national income. A significant share of remittances to India continues to be contributed by inflows from the oil exporting countries of Middle East. Thus, the behaviour of remittances to India is likely to be influenced by growth patterns in these countries, best represented in the form of oil prices. Another important source of remittance inflows to India is the US.

Findings of the Study

Between 1950 and 2008, the volume of world merchandise export has grown about 30 times. This expansion is more than three times faster than growth in world GDP, which expanded eight-fold during the same period. Growth of world GDP is associated with an even higher growth in international trade.

Opening the economy to the world markets and subjecting it to greater market discipline are at the heart of the success the Indian economy has achieved so far. Growth in trade has been an integral part of India's growth story so far in the 1990s and 2000s. The multi-pronged strategy undertaken in the beginning of the 1990s gradually had its desired effects on the economy and ushered in a phase of stable and higher growth in trade. The services export of India has undergone a structural shift since 2003-04, driven by the emergence of new avenues of services exports attributed to a rapid expansion in international trade and investment facilitated by an increased liberalisation and the use of technology enabled services. The increase in international

labour migration from India since 1980s has major impacts on balance of payment through financing a large part of trade deficits as well as a part of current account deficits.

The association between exports and economic growth is often attributed to the positive externalities for the domestic economy arising from participation in world markets like reallocation of existing resources, economies of scale and various labour specialisation effects.

The study highlights that there exists a robust and long run relationship between exports and economic growth in case of Indian economy and an uni-directional causality from export growth to GDP growth. This also indicates that one can use exports to better predict the GDP than simply by the past history of GDP. The empirical evidence indicates that the movements in the exports of goods and services appear to lead the movement of GDP in Indian economy.

Conclusion

India has of late emerged as a leading proponent of the services trade liberalization under the GATS. The focus of services trade has shifted from facilitating trade in goods to trade in services as an independent entity in itself with the four modes of supply for the delivery of services in cross-border trade.

The major impacts of international labour migration from India on the balance of payments were through remittance inflows, which financed a large part of trade deficits, and through repatriable deposits, which financed part of the current account deficits. It is of course, difficult to disentangle the impact of migration on exports and growth.

Given the recent success of software exports from India along with the focus

area approach to merchandise exports including its diversification, the finding is plausible and consistent with prior expectation that growth of exports – both merchandise and services stimulates economic growth.

Economists across the board have agreed with the opinion that the process of economic growth is an extremely complex phenomenon. It depends on many variables, such as, capital accumulation (both physical and human), openness of trade and capital accounts, price stability, political situation, income distribution, and even on geographical factors. Export-led growth (ELG) hypothesis postulates that export expansion is one of the prime determinants of economic growth of an economy. Growth can be attained not only by increasing the amounts of labour and capital within the economy, as the classical economists postulates, but also through foreign trade multipliers. According to proponents of ELG hypothesis, exports can perform the function of an *engine of growth*.

The contents of the publication are based on information available with Export-Import Bank of India and on primary and desk research through published information of various agencies. Due care has been taken to ensure that the information provided in the publication is correct. However, Export-Import Bank of India accepts no responsibility for the authenticity, accuracy or completeness of such information

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