CHAPTER-2

2 The Global Economic Situation and India's External Sector

Introduction

The global economic slowdown and the sovereign debt crisis which had led to a stagnation in World output continued to pose challenges in 2013-14.

The speculation on the Quantitative Easing policy of the United State (US) government led to outflow of Foreign Institutional Investments and significant depreciation of developing economy currencies including that of India. However, the situation improved in the second quarter (Q2) with gradual recovery in growth among world economies. Growth in developing and emerging markets finally picked up after a slowdown in the first quarter of 2013-14.

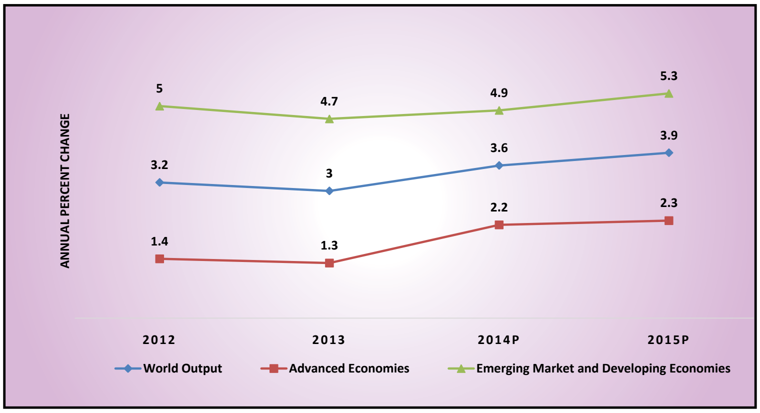
For India, economic growth remained below 5% for the second year in a row at 4.7% in 2013-14 (as per the provisional estimates of CSO), mainly due to decline in manufacturing output. Upward pressure from food and fuel prices kept overall inflation high prompting the Reserve Bank of India (RBI) to go with a tight monetary policy. On the other hand, low tax revenue and high spending on subsidies affected fiscal consolidation. The challenges for the new government after the General election of 2014 is the simultaneous tackling of two sets of issues, increasing growth and undertaking fiscal consolidation. Achieving growth above 5% in 2014 will require sustained improvement in manufacturing sector growth and performance.

I. Global Economic Growth: An Overview

The global economy started reviving, after dealing with the prolonged effects of the global crisis. Economic activity revived in developed countries, though downside risks persist due to tight financial conditions. The IMF World Economic Outlook (WEO), highlights that global economic activity has picked up during the second half (H2) of 2013 with expectation of further improvement in 2014–15. The outlook has projected world growth at 3.6% in 2014 and by 3.9% in 2015. The projections made by IMF are higher than the one made by the United Nations (UN) in its World Economic Situation and Prospects (WESP), 2014 and World Bank, Global Economic Prospect (GEP), 2014. The projection by World Bank stood at 2.8% and 3.4% for 2014 and 2015 respectively while, as per the UN projection the global economy is expected to grow at the rate of 2.8% and 3.2% in 2014 and 2015 respectively. Both IMF and World Bank maintain that the recovery in the global economy will be supported by improvement in the advanced/ high income economies. As per IMF, growth of AEs (Advanced Economies) is projected to strengthen from 1.3% in 2013 to 2.2% in 2014 and further to 2.3% in 2015.

As per the Organization for Economic Co-operation and Development (OECD) the global economy will grow by 3.4% in 2014 and by 3.9% in 2015. The OECD economies will grow by 2.2% and 2.8% in 2014 and 2015 respectively.

Chart 2.1:
Growth Dynamics (2012-2015P)



Source: IMF, WEO April 2014

Economic conditions are expected to gradually improve in 2014, which will primarily be driven by good performance of advanced/high income economies (IMF, 2014). The major stimulus/boost is expected to come from the US. The US is projected to grow at 2.8% and 3.0% in 2014 and 2015 respectively. The Euro area is expected to realize growth of 1.2% in 2014, after contracting by about 0.5% in 2013. For Japan, growth is expected to drag down from 1.5% in 2013 to 1.4% in 2014.

As per the IMF, the performance of the Emerging Market and Developing Economies (EMDEs) picked up in the H2 of 2013. Exports improved with stronger activity in the advanced economies and currency depreciation.

Table 2.1:
World Economic Growth Estimates for 2013 - 2015 (Annual percentage Change)

	UN			IMF			World Bank		
	2013	2014f	2015f	2013	2014P	2015P	2013e	2014f	2015f
World	2.2	2.8	3.2	3	3.6	3.9	2.4	2.8	3.4
Developed economies/ Advanced Economies/High Income	1.1	2.0	2.4	1.3	2.2	2.3	1.3	1.9	2.4
Euro Area	-0.4	1.2	1.6	-0.5	1.2	1.5	-0.4	1.1	1.8
US	1.9	2.5	3.2	1.9	2.8	3.0	1.9	2.1	3.0

Japan	1.5	1.4	0.9	1.5	1.4	1.0	1.5	1.3	1.3
Developing Countries/ EMDEs	4.6	4.7	5.1	4.7	4.9	5.3	4.8	4.8	5..4
Latin America and Caribbean (LAC)	2.7	2.6	3.4	2.7	2.5	3.0	2.4	1.9	2.9
Brazil	2.3	1.7	2.8	2.3	1.8	2.7	2.3	1.5	2.7
Russia	1.3	1.0	1.5	1.3	1.3	2.3	----	----	----
India	4.8	5.0	5.5	4.4	5.4	6.4	4.7	5.5	6.3
China	7.7	7.3	7.1	7.7	7.5	7.3	7.7	7.6	7.5

Sources: UN, World Economic Situation and Prospects, 2014; IMF, World Economic Outlook, April 2014; World Bank, Global Economic Prospects, June 2014.

e= estimates, f=forecast, p=projections, '----' data not available.

On the other hand, investment will remain weak. The projected growth rate for EMDEs as per IMF stands at 4.9% for 2014 and 5.3% in 2015.

The forecast for China by IMF stood at 7.5% in 2014. The IMF projection for China is similar to the projection made by Asian Development Bank, 2014 (ADB, 2014). For India the projection made by IMF stands at 5.4% in 2014, while according to ADB, 2014 India is expected to grow at the rate of 5.5% in 2014. Coming to Latin America, only modest improvement is expected for the region with growth projected at 2.5% and 3% for 2014 and 2015 respectively. For Russia growth prospects get affected by geopolitical risk. The projections for Russia stands at 1.3% and 2.3% for 2014 and 2015, respectively.

II. Global Trade: Changing patterns

The World Trade Report, 2013 by the World Trade Organization (WTO) highlights that trade has increased at a faster rate than global output. Developing countries have gained importance, such that the share of the developing economies has risen to 47% of global exports in 2011 up from 34% in 1980. The major surge came from China making it the largest exporter with an increase in its share to 11% in 2011 from 1% in 1980. Regional trade gained importance. The share of intra-regional trade in Asian exports increased to 52% in 2011 from 42% in 1990, but intra-regional trade shares in Europe and North America have remained steady or declined.

According to the report, it is important to measure trade in value added terms as international supply chains play a major role today. If measured in value-added terms, the contribution of services to international trade is much higher.

III. Trade Slowdown

Global trade growth reduced from 2.3% in 2012 to 2.1% in 2013. As per the WTO, global trade is expected to grow by 4.7% in 2014 and by 5.3% in 2015. However, the growth of

4.7% in 2014 is still below the 20 year (1983-2013) average of 5.3%.

As per the current rankings, India is the 19th largest exporter (with a share of 1.7%) and 12th largest importer (with a share of 2.5%) of merchandise trade in the world. China is the top ranked exporter and the US largest importer of merchandise trade in the world. In Commercial Services, India is the 6th largest exporter (with a share of 3.3%) and 7th largest importer (with a share of 2.9%). USA is the top exporter as well as the top importer of commercial services in the world.

Global trade prospects: As per the WTO, in 2014 exports growth will be fastest from Asia growing at a rate of 6.9%. Exports will be supported by rising import demand from developed countries with improvement in US and Europe. In 2015 merchandise trade is projected to grow by 5.3%, with developed and developing economies posting increases of 4.3% and 6.8% in exports as well as increase of 3.9% and 7.1%, respectively on the import side.

IV. India's Trade

The global economic situation is a major determinant of export performance of any country, thus export growth cannot be viewed in isolation. With the global economy continuing to be volatile, India's export growth performance in the last one and a half years has been much below the past trend. The current account deficit in India reached unsustainable levels as the Indian rupee came under heavy pressure in May following concerns raised by the US Federal Reserve announcement on tapering the quantitative easing policy stimulus.

However, external risk has considerably lowered after Q1 as Current Account Deficit (CAD) as a percentage of GDP came down to 0.2% in quarter four (Q4) of 2013-14 after declining from 4.9% in Q1. The main reason behind the decline was growth and improvement in exports and measures taken by government to curb import of gold. India's exports began to improve after Q1 with economic recovery in key trading partners. On the other hand, imports contracted primarily due to sharp decline in import of gold.

India's merchandise exports reached a level of US$ 312.61 billion during 2013-14 (P) registering a growth of 4.1 percent as compared to a negative growth of 1.8 percent during the previous year. Despite the recent setback faced by India's export sector due to global slowdown, merchandise exports recorded a Compound Annual Growth Rate (CAGR) of 15 percent from 2009-10 to 2013-14 (P).

The cumulative value of imports for the year 2013-14(P) was US $ 450.1 billion as against US $ 490.7 billion during the corresponding period of the previous year registering a negative growth of 8.3 per cent. India's total merchandise trade as a percentage of GDP was 43.8 per cent in 2013-14. India's merchandise exports as a percentage of GDP was 17.9 per cent in 2013-14.

The trade deficit in 2013-14(P) was estimated at US $ 137.5 billion which was lower than the deficit of US $ 190.3 billion during 2012-13.

V. Strengthening India's Growth and Exploring Newer Trade Terrains

External sector risks have been considerably lowered after Q1. With a gradual recovery in key partner economies, India's exports began to improve after the first quarter supported by the depreciation of the rupee. The top items that have high share in India's merchandise exports are petroleum products, gems and jewellery, transport equipment, machinery and instruments, drugs, pharmaceuticals and fine chemicals, manufactures of metals, cotton including accessories, cotton yarn fabrics madeups etc, electronic goods, plastic and linoleum. However, a major problem faced by India is the import dependence of exports. Import dependence is high in case of petroleum products and Gems and Jewellery. In terms of the current trends in economic growth, the aim of government is to broaden the scope of India's trade and expand its potential to newer trade fields.

In order to bring greater momentum to India's growth process, focus has been on exploring wider and newer areas that have greater export potential. In this regard, two major areas which may be focused upon are: **E-Commerce and Global Value Chains (GVCs)**. In the current global economic scenario, e-commerce has emerged as an innovative and rapidly expanding technique of promoting, selling and buying commodities.

E-commerce means sale or purchase of goods and services conducted over network of computers by methods specifically designed for the purpose of receiving or placing orders. According to Internet and Mobile Association of India (IAMAI), the E-commerce market in India has witnessed a CAGR of 54.6% during 2007-11 (IAMAI, Aranca Research). Most of the transactions in India are of Business to Business (B2B) nature. In India under the Business to Consumer (B2C) transaction, the travel segment accounts for 81.4% of the entire market in 2011. Greater scope exists in online retail with increased internet penetration and advent of 3G/4G telecom services.

When it comes to Foreign Direct Investment in e-commerce category, views appear to be divided among various stakeholders. E-commerce including online retail constitutes a small fraction of total sales but is set to grow due to factors such as rising disposable incomes, rapid urbanization, rising youth population.

Another potential area which may aid India's economic growth is through linking India to GVCs. Participation of a country in GVCs can be assessed through what percentage of a country's exports are part of GVCs. Two types of participation are backward participation (use of foreign intermediaries in India's exports) and forward participation (use of Indian intermediaries in other countries exports). In case of India, backward participation is higher than forward participation (OECD-WTO Trade in Value Added (TiVA)).

As per the Organisation for Economic Co-operation and Development (OECD), India participates in manufacturing GVCs for chemicals, electrical equipment and manufactures (e.g. jewellery). In case of services major participation is in business services, mainly driven by the use of Indian intermediaries in the exports of other countries. Policies are now being undertaken to encourage Indian producers to capture higher value from GVCs, so that they move up the value chain by performing value added activities.

The gain from GVCs depends upon the value a country creates in GVCs. India specific indicators on GVCs based on OECD-WTO Trade in Value-Added (TiVA) database shows that India's domestic value added content in final demand across countries was 74% in 2009, while the foreign value added share was 26% in 2009. On the other hand, share of India in value added exports was 1.9% of world exports in 2009.

GVCs are fast picking up in world markets and India is also integrating itself with changing world production structure. Policy makers are aiming at diversifying India's markets in order to reap the benefits of growth in value added products and services. These newer avenues in the world market provide greater potential for India to strengthen its value added share in world trade. Interconnecting with economies in production chains will help build robust growth of manufacturing and services in India.

Way Ahead

Weak growth and exchange rate depreciation characterized the Indian economy in the initial months of 2013-14. The economy also witnessed a parallel widening of the current account deficit to 4.9 % of GDP in the Q1 of 2013-14. The economy bounced back such that the CAD narrowed sharply to US $ 1.2 billion (0.2% of GDP) in Q4 of 2013-14 from US $ 18.1 billion (3.6% of GDP) in Q4 of 2012-13. The decline in CAD was primarily due to decline in import of gold and improvement in exports.

The economy is still grappling with issues which need to be addressed in order to further bring down the current account deficit. Thus, India has to deal with the twin issues of boosting exports and bringing down the import content of exports (reducing the dependence on foreign intermediaries for production).

There is a need to make business entrepreneurs aware of the upcoming growth focus on enhancing exports from Micro Small and Medium Enterprises (MSME) Sector in areas such as: Pearls and precious stones, apparel and accessories, pharmaceutical products, leather goods, electrical & electronic equipment etc., along with emphasis on issues such as: Technology development, Standardization, Compliance Platform, Identifying and nurturing specific sectors with significant export potential etc.

The WTO's permits an exporting country to provide tax concessions on exported products and on inputs consumed in the production of the exported product. However, for the exporting country to avail all this benefit, exporters need to establish an unbroken trail of all indirect taxes paid on the exported product and on the inputs consumed in its production process. In the absence of uniform Goods and Services Tax (GST) in India, frequently exporters are unable to get rebate or drawback on all indirect taxes paid on the exported product and its inputs. This significantly enhances the final price of the exported product.

The current global situation offers an opportunity for measures to strengthen the business environment, attract more Foreign Direct Investment (FDI), and increase productivity. These measures would include steps to reinforce the financial sector via capitalization and broader banking/financial sector reforms, simplifying the regulatory environment for firms, and strengthening fiscal balances through continued fiscal discipline and the adoption of GST. The reform momentum has accelerated in the last several months, and further steps to boost greater growth are expected to be undertaken to achieve medium term and long term growth targets.

In the coming months, macroeconomic environment is expected to improve and growth is expected to accelerate gradually over the next two years. The situation provides an opportunity to accelerate growth through promoting exports and enabling growth in upcoming market segments. The business and trade segments of e-commerce and global value chains provide an opportunity to compete at par with other world economies and expanding our technology base.

The above findings underscore the imperative for extensive domestic reforms in all areas of logistics, manufacturing, fiscal, financial and overall economic performance on the part of both the government and industry, with targeted initiatives for improving infrastructure and international shipments required on a priority basis. In an increasingly globalised and integrated economy, unless domestic reforms, productivity, quality, standards related issues etc. are addressed and benchmarked against global competitors our exports cannot grow at the desired rate.