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The Indian economy in the era of financial globalisation

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India's greater openness to the world market: A new position in the global division of labour?

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Major transformations have taken place in the Indian economy since the payments crisis in 1991 and the subsequent introduction of the New Economic Policy. One aim of the reform has been to open up the Indian market to foreign trade. Access to foreign investors has also been eased, enabling large inflows of capital, mainly in the shape of indirect investment by foreign financial institutions. However, a myriad of procedural, administrative and quantitative restrictions on capital flows still remain.

India's position in the global division of labour still bears the stamp of development policies implemented since 1947, which sought to promote industrialization through import substitution. Exports of traditional goods (mainly primary and lower-end manufacturing goods) were intended to finance imports of capital goods that could not be produced domestically. Trade barriers (both tariff and non-tariff) shielded national industries. In the longer term these policies resulted in technological backwardness. The opening-up of India's economy has enabled producers to access better technology and cheaper sources of intermediate goods and raw materials, but it has also entailed a persistent trade deficit.

The aim of this paper is twofold: in the first section, it assesses the changes in Indian patterns of trade goods, by product and partner, through 1993-2004. We conclude that opening was asymmetrical, leading to high trade deficits. In the second part, we focus on the global balance of payments. Funding the balance of payments relies on volatile flows like portfolio investment and Indian non-resident remittances, thus threatening macro-economic stability. We conclude by pointing out that balance-of-payments vulnerability, a consequence of financial globalisation, hampers growth.

A. Slow change in the product composition of trade and in partnerships

India's foreign trade grew relatively quickly between 1993 and 2004; exports rose at a compound annual rate of 17%, imports at 20%. The growth rate for exports thus lagged behind the rate for imports, a reversal of the trend before the reforms. Between 1980 and 1992, exports grew at a compound annual rate of 18%, imports at 15%.

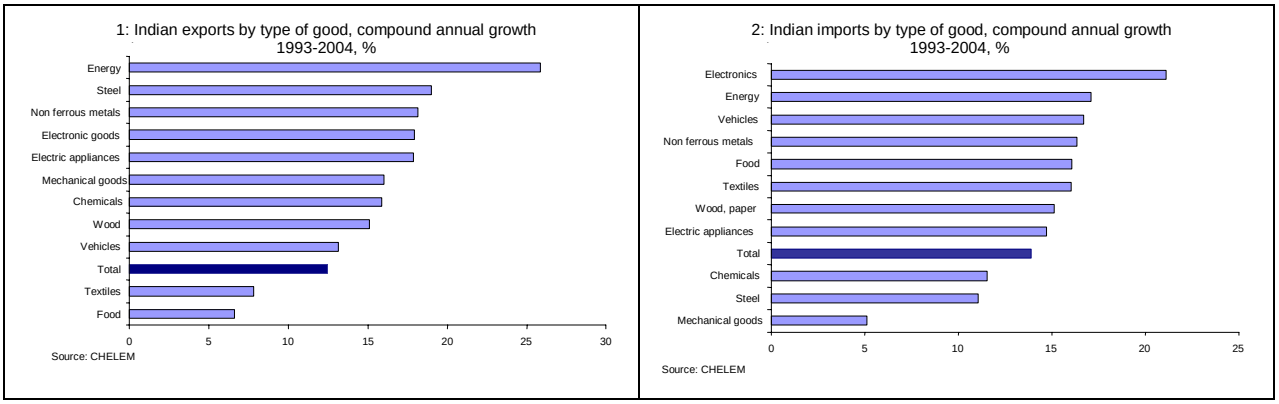
I. India's trade by products

Exports: traditional goods remain dominant but their share has declined sharply.

Though traditional goods registered the slowest growth rates during 1992-2004 (less than 10%) and their share has declined sharply, they still accounted for more than 50% of exports in 2004. Food represented 10% in 2004, compared to 34% in 1980, and textiles 20%, compared to 28% in 1980 (Chart 1).

Energy, steel, non-ferrous metals, electrical and electronic goods are the fastest growing export items, accounting for more than 20% of the total in 2004. As growth started from a low base, however, these goods (except energy and steel) do not account for more than 2% each of total exports. Chemicals grew at a rate of 16% a year, amounting to 15% of total exports in 2004 compared to only 6% in 1980 (Chart 3).

Charts 1 & 2

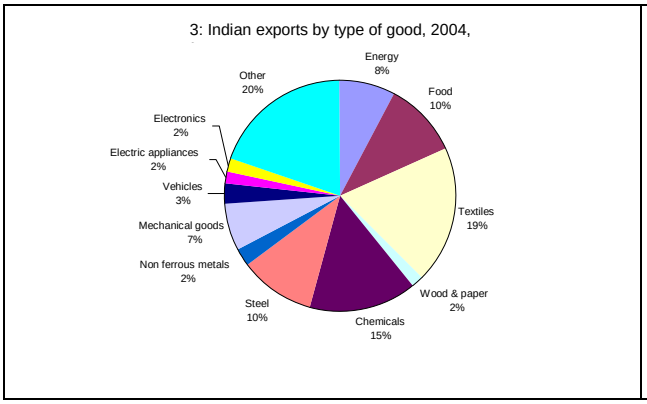


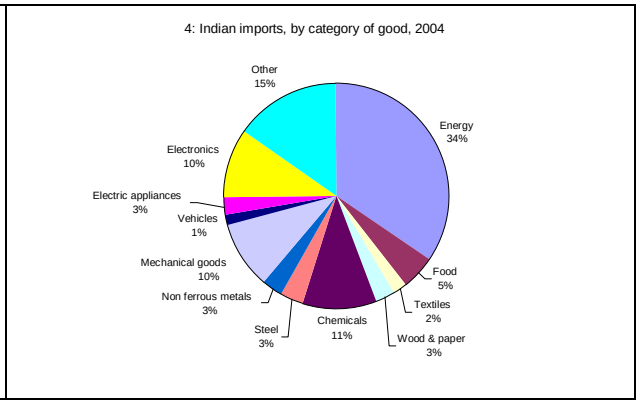
II. Imports, more than exports, show how much India has opened up

Imports show the extent of India's integration into the world market. Electronics and textiles have increased as a share of total imports, indicating a certain degree of productive integration, since imports of such goods were practically non-existent in 1980 (Chart 2). Due to India's specialization in information technologies, electronics are the fastest growing segment, accounting for 10% of total imports in 2004. Energy is next, because of India's substantial deficit in natural and man-made energy sources.[1] Notwithstanding these shortfalls, energy has declined sharply as a proportion of total imports compared to 1980, when it accounted for 43% (Chart 4). Vehicles, metals, food and textiles have grown relatively fast, but their share in 2004 shows little change compared to 1980.

[1] Nuclear energy accounts for only 2% of total energy needs.

Charts 3 & 4





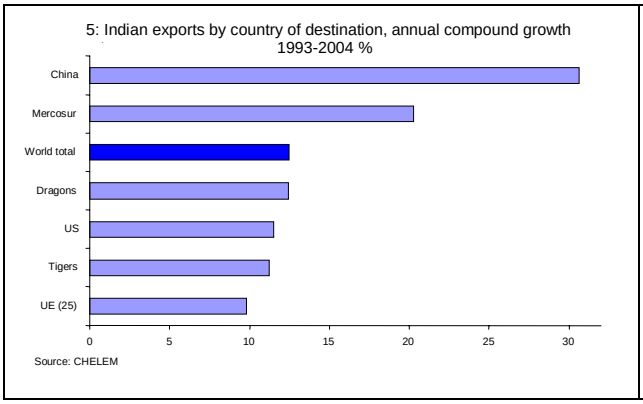
This rapid overview of India's foreign trade shows that although the composition of trade has changed, traditional goods still predominate. Greater openness has not yet brought about a profound change in India's position on the world market. Despite having relaxed its import substitution policies, India has not by any means become a second "world workshop" after the Chinese model.

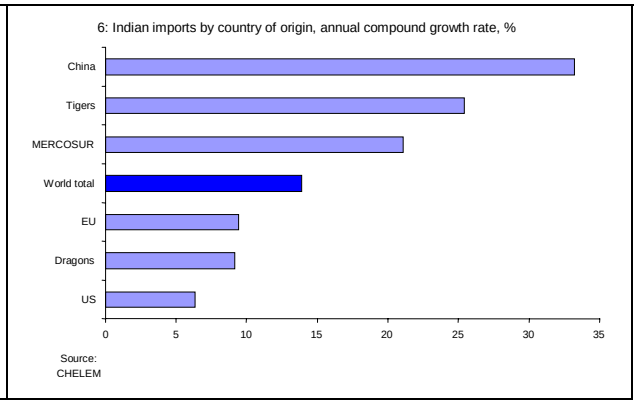
III. India's main partners are still roughly the same, but partnerships with developing Asian countries are growing

India has registered high growth rates in markets where it had small shares, such as emerging Asia ("dragons" and "tigers"[2]) and Mercosur (Chart 5). Emerging Asian countries have helped to boost India's export growth to the point where dragons, tigers and China (including Hong Kong) together accounted for 23% of total Indian exports in 2004 (Chart 7). The European Union remains one of India's main export destinations with 22% of the total, while the United States accounts for 16%.

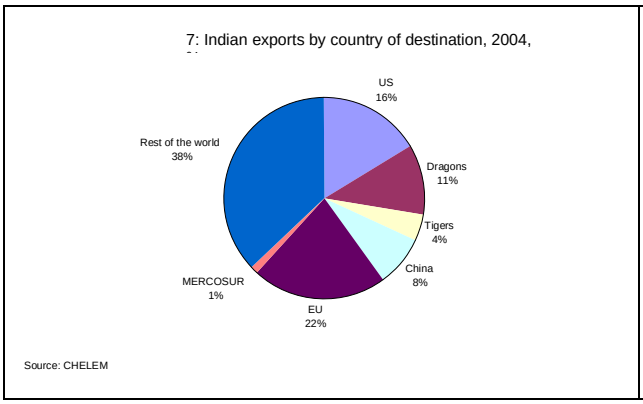
The European Union is easily India's leading source of imports, supplying 21% of the total, while the United States accounts for only 5% (Chart 6). Emerging Asian countries (dragons, tigers and China including Hong Kong) account for another 20%, while Gulf states (the main source of imported oil) represent 11% (Chart 8).

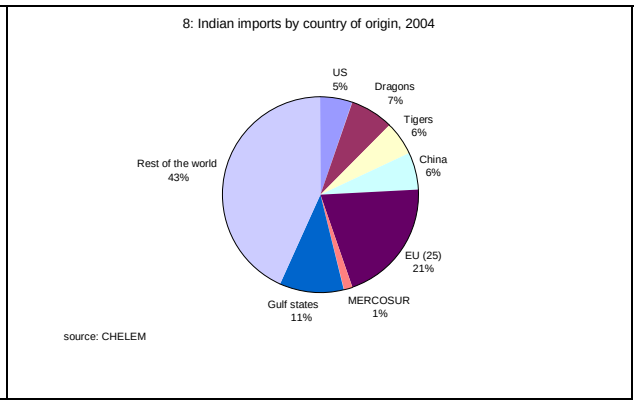
Charts 5 to 8





[2] The "dragons" are South Korea, Singapore and Taiwan. The "tigers" are Indonesia, Thailand, Malaysia and the Philippines. The smaller countries in the South East Asian region are not taken into account.





IV. Exports by type of goods and country of destination: considerable differences from one market to another

Though India's export trade is mostly driven by traditional goods such as food and textiles, the composition of exports varies according to the country (or region) of destination.

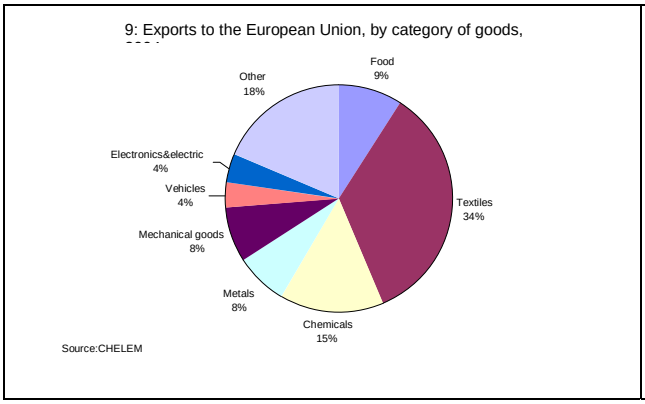
Exports to the European Union consist mostly of textiles, metals and food; together, these goods account for half of total exports to the region (Chart 9). The share of chemicals has increased sharply in the recent past, amounting to 15% of India's total exports to the EU in 2004.

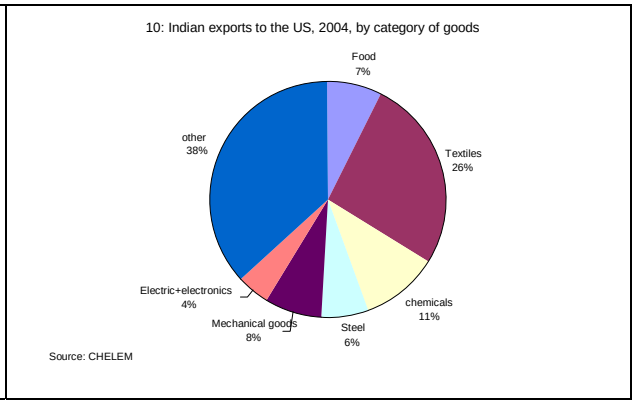
India's exports to the United States mostly comprise textiles, steel and food, which account for 39% of the total, while chemicals account for 11% and mechanical goods for 8% (Chart 10).

Surprisingly, exports to China consist mostly of metals, especially steel (almost 70%). Chemicals account for 16% (Chart 11).

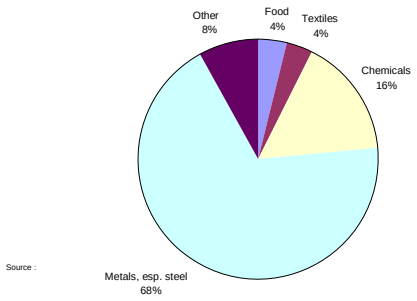
Chemicals account for 25% of exports to the tigers, and textiles and food for 30% (Chart 12). Exports to the dragons consist of energy (22%), textiles (9%), metals (9%), chemicals (7%), food (5%) and mechanical goods (5%) (Chart 13).

Charts 9 to 13



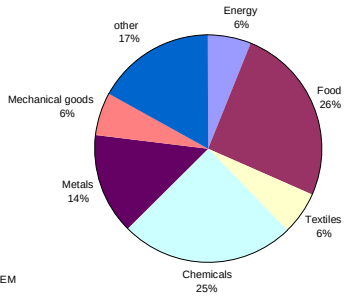


11: Indian exports to China, by category of goods,



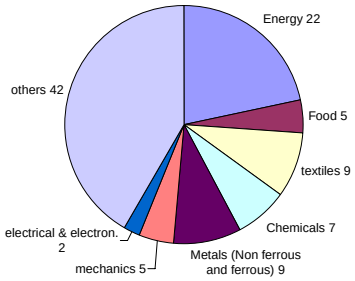
Source :

12:ndian exports to the tigers, by category of goods, 2004



Source: CHELEM

13. Indian exports to the dragons, 2004



source: CHELEM

V. Imports by type of goods and country of origin

Imports from th**e** European Union mostly consist of mechanical goods (21%), chemicals (12%) and electronics (11%) (Chart 14).

Electronics (22%), mechanical goods (21%) and chemicals (22%) are also the main goods imported from the US (Chart 15).

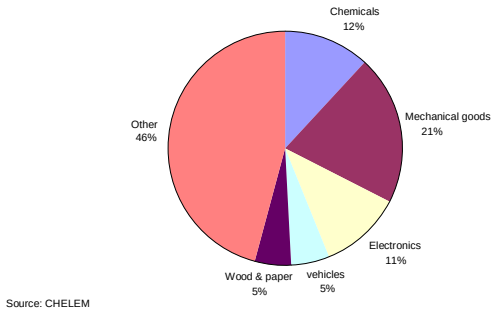
Imports from the dragons mainly consist of electronics (38%), mechanical goods (13%) and chemicals (13%), while imports from the tigers are essentially food (36%), electronics (17%), energy (15%) and chemicals (13%) (Charts 16 and 17).

India's imports from China consist of electronics, (28%), chemicals (21%), textiles (11%) and energy (10%) (Chart 18).

Imports from the Gulf states**,** consist of energy (17%), chemicals (16%) and metals (8%) (Chart 19).

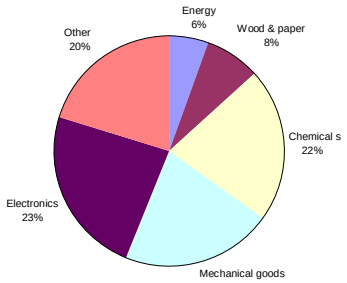
Charts 14 to 19

14: Indian imports from the EU, by category of goods, 2004



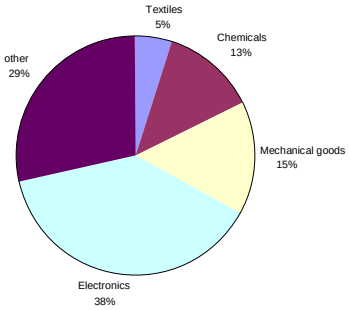
Source: CHELEM

15: Indian imports from the US, by category of goods, 2004



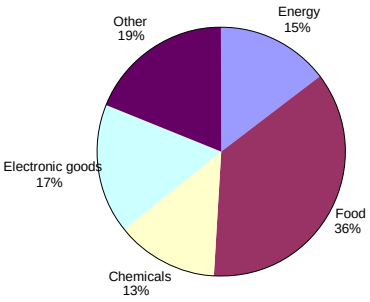
Source: CHELEM

16: Indian imports from the dragons, by category of goods, 2004



Source: CHELEM

17: Indian imports from the tigers, by category of goods, 2004



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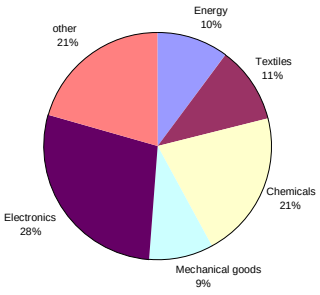
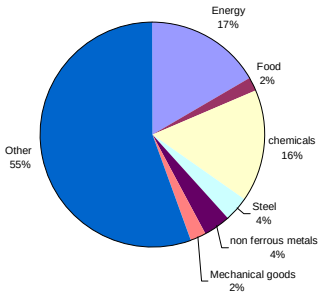
18: Indian imports from China, by category of goods, 2004



Source: CHELEM

19: Imports from the Gulf countries, by category of goods, 2004



Source: CHELEM

These numbers show that India is slowly moving away from traditional exports, but that this change is also due to a more diversified range of trading partners. New partners, especially in other Asian countries, are importing other goods than textiles and food from India, while traditional goods are more likely to be the main imports of developed countries.

With regard to textiles, far-reaching changes may be expected as a result of the dismantling of the Agreement on Textiles and Clothes (ATC) in January 2005. The effects for India have not been as beneficial as some models had forecast (Box).

Box: Consequences of the dismantling of the ATC

The dismantling of the ATC and its export quotas has resulted in a redistribution of market share among the world's main producers. A study commissioned by the WTO (Nordas, 2004) concluded that India would be one of the main beneficiaries of the measure. It expected that India and China would increase their share of the EU fabrics market by a further two points, though only China would improve its share of the US market. The ending of the Agreement was likely to be more beneficial for China as far as clothes are concerned: the study estimated that China's share of the US market would increase by a further 36 points, giving it 50% of US imports of clothes, with India's share improving by 11 points to 16%. However, initial results in 2005 were much less favourable for India than forecast, in terms of both market share and growth rate (see table).

Gains on market share by India and China, as of mid-2005

(In percentage points)

	United States		European Union
	Fabrics	Clothes	Textiles and Clothes
China	4.2	8.3	7.7
India	0.4	0.9	0.7

Source: *Asian Development Outlook 2006*, ADB and computation by the author.

India increased its share of the American market for fabrics by 0.4 point, and China by 4 points. The differential was even greater on the clothing market. China accounts for 40% of fabric imports into the US market, and India for 12%. The equivalent figures for clothing are 60% and 22%. China's and India's shares of the EU market are 31% and 7.5% respectively.

The Indian textile industry's lack of competitiveness is structural: small production units and low technology stem from former policy choices which reserved these industries for small firms. Though most of the goods in this category have now been de-reserved, producers are still hindered by lack of capital and investment.

VI. A persistent trade deficit

Trade deficits have increased since 1992, whatever India’s position in the business cycle. India's export trade has failed to improve sufficiently, in either its composition or its destinations. Conversely, the domestic market has been extensively opened up and Indian industrialists have grasped the new opportunities offered by reform to buy more efficient and modern equipment than that available on the local market. But technological improvements in Indian manufacturing do not seem to have made the country more competitive on the world market.

Two main factors explain this trade gap: higher levels of FDI and weakness in exporting new products on the part of Indian firms. As the Indian goods market was opened up alongside capital markets, foreign direct investment brought about a surge in imports. However, foreign companies were interested in the domestic market and were not looking to use India as an export platform. Consequently, the rise in imports was not offset by a corresponding increase in exports. At the same time the local market became more competitive; as domestic producers had to remain competitive with foreign firms, they needed to upgrade their technology and improve their productive capacity by means of imported equipment.[3] Competition squeezed profit margins, so that Indian firms had to seek more profitable markets

[3] This triggered a huge wave of investment between 1993 and 1997.

abroad. But only traditional exporters were ready to do so and the composition of exports inevitably remained roughly the same. These two factors explain the asymmetry between export and import growth.

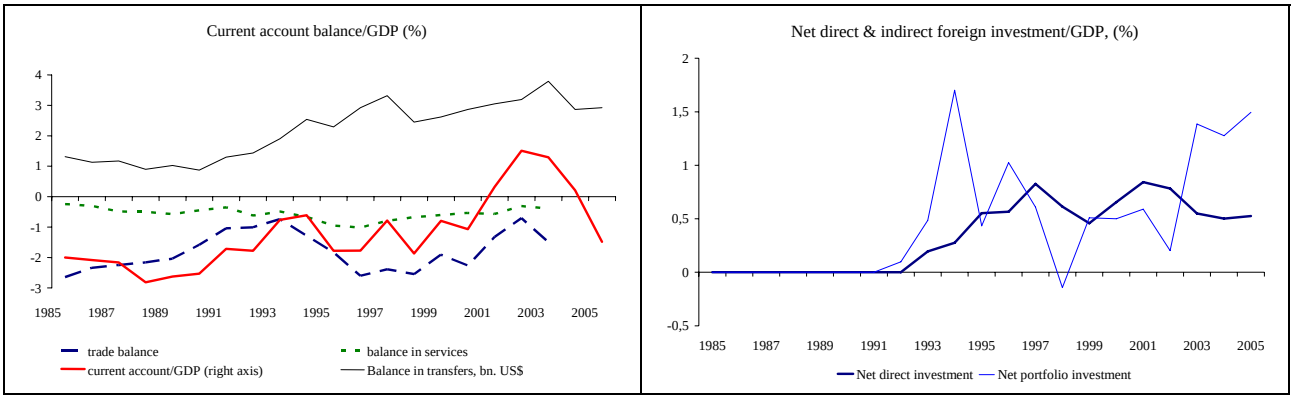
B. Balance of payments weaknesses remain

I. The trade balance in both goods and services is in deficit

India's trade balance in goods is systematically in deficit, but a more open economy meant that the deficit in 2004 was more than twice the deficit in 1993. Many authors claim that the trade gap is at least partially offset by a large surplus in the balance in services but this claim is controversial, as the Indian and IMF accounting systems produce differing statistics.

The differences mostly stem from bilateral trade between the US and India. The RBI (Reserve Bank of India) considers the salaries of all Indian residents in the US and working in the IT sector, to be exports of IT services, while the US includes only the salaries of Indian temporary residents. The IMF follows the US criteria, producing in 2000, a deficit in services of $2 billion a year or more, rather than a surplus of approximately the same amount. The following years show also a deficit of variable amounts.

Charts 20 & 21



In these conditions, the deficit in trade and services is balanced only by remittances from non-resident Indians abroad and, occasionally, by portfolio investment inflows. India had a current account surplus from 2001 to 2004 but not in 2005. The overall balance is financed by inflows of capital, mainly portfolio investment, from foreign international institutions like pension funds and hedge funds.

Even if India has so far a solid reserves position, its current account is fragile because it is financed mainly by flows of funds that are unstable by nature.

II. Greater openness in a global financial context hinders stability in countries like India

Financing the global balance of payments by means of portfolio inflows from foreign financial investors goes hand in hand with reforms in the domestic financial system. This

gives more scope to the stock market, thus limiting the role of the banking system as the main "risk-taker" in the economy as a whole. Most of the time, portfolio inflows are hot money; although they have helped to enhance the stock market, they have also left Indian financial markets more vulnerable to crises and tensions abroad. Greater volatility and instability are particularly dangerous in developing countries unable to hold fluctuations in check.

The reason for this greater sensitivity to volatility is that financial markets in developing countries are much shallower than in developed ones. This is the case with India, where only a few firms are actively traded in the market (30 out of more than 8,000 listed stocks, according to Chandrasekhar, 2006[4]) and they are quoted only a few days in the year.

Intervention by institutional investors causes share prices to rise; corrections, when they occur, lag behind and are much sharper. As institutional investors are mostly foreign, a close link exists between the stock market and the foreign exchange market, thus compounding both effects. Sometimes, retrenchment from a market is due to reasons that have nothing to do with the local market. Furthermore, shallow markets are prone to manipulation by big investors like pension funds and hedge funds.

All in all, relying on these inflows to finance the current account deficit imposes severe constraints on economic regulation. Consequently,

- strict anti-inflationary policies are necessary, as inflation erodes financial returns;
- fiscal deficits are prohibited, as government intervention on financial markets may disturb market conditions and could result in manipulation of interest rates contrary to the interests of financial investors;
- monetisation of fiscal deficits ought to be definitively abandoned and replaced by the issuance of debt on financial markets;
- inflows of hard currency cause the local currency to appreciate, thus hurting exporters' competitiveness and causing even greater reliance on portfolio inflows in order to finance the balance of payments.

These policies are recessive and, given India's systematic current account deficit, hamper growth and sustain the deficit.

[4] **Chandrasekhar, C. P. (2006),** *Financial Liberalization and Macroeconomic Policy in India*, in : International conference on 'Post Liberalisation Constraints on Macroeconomic policies', January 27-29, 2006, Muttukadu, Tamil Nadu, India**.** www.networkideas.org