Impact of Global Recession on Indian Exports: Performance and Policy Implications

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ABSTRACT

When the recent crisis gripped the world 2008, most policymakers, economists and experts put forth the view that India would be only marginally affected. But the contagion of the crisis has spread to India through three major channels – the financial channel, the real channel, and importantly, as happens in all financial crises, the confidence channel. The decline in the exports as a result of declining demand in the world market was the major factor which affected Indian economy not only in the export intensive sectors but other sectors too. It is worthwhile to examine the changes in volume and composition of the export during recession period. The present paper made an effort in this direction. The paper aims to understand the various aspects of the impact of the recession with particular reference to the exports of India.

Keywords: Global Recession, Indian Exports, Fiscal Policy

1. INTRODUCTION

The recent global recession, considered worst since the great depression of 1930s, has started in the U.S. economy and gradually spread to the other developed and developing countries with varying degree. Initially it was considered that the recession would not affect the Indian economy in a big way because of ‘decoupling hypotheses. But with the spread of the recession in other advanced economies, the Indian economy started feeling the strains with declining demand of the Indian exports. The export sector was first to feel the heat of the recession.

When the crisis gripped the world 2008, most policymakers, economists and experts put forth the view that India would be only marginally affected. But the contagion of the crisis had spread to India through three major channels – the financial channel, the real channel, and importantly, as happens in all financial crises, the confidence channel. The decline in the exports as a result of declining demand in the world market was the major
factor which affected Indian economy not only in the export intensive sectors but other sectors too. It is worthwhile to examine the changes in volume and composition of the export during recession period. The present paper made an effort in this direction. The paper aims to understand the various aspects of the impact of the recession with particular reference to the exports of India.

The present paper is organized in six parts. Part-II of the paper discusses the causes of recession. Part-III of the paper analyses the channel of spread of the recession to India. Part-IV analyses the impact of the Recession on Indian Exports. Part-V discusses the policy measures adopted by Indian Government to boost the exports. The conclusions and important suggestions are presented in the last Part-VI.

2. CAUSES OF RECESSION

The causes of the crisis have become a major topic of discussion among both economists and policymakers. The crisis originated in US in 2007 but its seeds were sown in 2001 when the US economy experienced a mild short lived recession. Most contributions to the ongoing post-mortem analysis of the crisis recognizes that government failure has played a major role in allowing banks and other financial institutions to capitalize on loop-holes in the regulatory system to increase leverage and returns. Another important explanation of the crises is the market failure, namely the catastrophic performance of the financial market that was in stark contrast to the theoretical proposition that it is efficient. The four market failures that are believed triggered and amplified the financial crisis of 2007-2010 are (i) Risk-Taking Incentives of Financial Institutions (ii) Systemic Risk of Financial Institutions (iii) Opacity of Financial Institutions and Markets (iv) Runs on the System. As a result of above market failures the financial/housing market have resorted to (i) Use of off -balance sheet entities and over-the-counter transactions (ii) Complex securitization of assets accompanied by lax risk analysis/assumptions (iii) Excessive leverage and reliance on short-term debt (repos) (iv) Remuneration incentives encouraged excessive risk-taking (v) Credit ratings agencies failure to accurately assess risk (vi) Aggressive mortgage lending and poor lending standards. The debate has considered both the contribution of domestic issues and global imbalances. To keep recession away the federal accommodated the monetary policy and lowered the funds rate 11 times and created a flood of liquidity lowering interest rate and rising housing prices, levels of standards were relaxed to the point that people were able to buy the houses. Therefore housing bubble and imprudent mortgage lending, failure of corporate governance and risk management, lack of transparency and accountability in mortgage finance leads to the collision of financial system. Lax regulatory environment permitted financial institution to engage in
risky transaction at a vast scale. Even many banks established off books special purpose entities to engage in speculative investment allowing the banks to make more loans during the expansion but also created contingent liabilities that with the onset of crisis reduced market confidence in the bank’s credit worthiness. Government also mandated subprime lending i.e. federal mandates to help low income borrowers. This excessive leverage bring the meltdown of financial system and caused the bankruptcy of many financial institutions like Lehman brothers in mid of 2007. As a result credit flows to the private sector were choked off, at the same time consumer’s and businessman confidence collapsed. The comprehensive review of crisis-related studies shows that both macroeconomic and microeconomic factors have played an important role in this global crisis.

3. TRANSMISSION CHANNELS

When the financial crisis erupted in USA, Indian policy makers and media persons argued that India would be relatively immune to this crisis, because of the strong fundamentals of the economy and the supposedly well-regulated banking system. The macroeconomic and financial indicators predominantly pointed to a strong and vibrant Indian economy prior to the financial crisis. The GDP was growing at the rate of 7.5%, 9.5%, 9.7% and 9% respectively for the years leading up to the crisis. The original consensus estimate for 2008-09 was also around 9%. A significant component of the growth in the Indian economy was the export sector. In the four years leading up to the crisis, India’s exports grew by more than 22% each year, averaging 25.8% during that period.

Dooley & Hutchinson (2009) identified that prior to May 2008, the EMEs were insulated from the financial crisis that had been severely affecting. The decoupling of the EMEs from the advanced economies broke down in May 2008 as the crisis spread to the rest of the global economy. This was apparent in case of India also as the financial meltdown, morphed in to a global economic downturn with the collapse of Lehman Brothers on 23 September 2008, the impact on the Indian economy was almost immediate. This is apparent in the case of India, as evidenced by the deterioration of all the macroeconomic and financial indicators in 2008-09. Industrial production increased by 2.7%, a significant drop from the 9.2% average growth in the previous four years. This contributed to the economy growing at only 6.7%. The BSE Index, which had been rising over a protracted period, lost 37.9% of its value, adversely affecting household wealth and the ability of businesses raising

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1 See, for example, the contributions in the special issue of Critical Review by Acharya and Richardson (2010), Astley et.al. (2009), Baily et al. (2008), Fox (2009), Garnaut (2009), IMF (2009), Krugman (2009a,b), Obstfeld and Rogoff (2009), Posner (2009), Reinhart and Rogoff (2009), Sheng (2009), Stiglitz (2010a & 2010b) and Taylor (2009& 2010).
money in the capital market (Vishavnathan, 2010)

Credit flows suddenly dried-up and overnight, money market interest rate spiked to above 20 percent and remained high for the next month. There were two distinct phases in 2008–09 during which the transmission of global shocks – through trade, finance and expectations channels – took place (Kumar, 2009).

a) **Financial channels:** this includes the banking sector, equity markets, external commercial borrowings and remittances. But Indian banking sector was not overly exposed to the subprime crisis. The Forex markets of India came under pressure due to sudden and large withdrawal of funds from FIIs. Simultaneously corporate were converting the funds raised locally into foreign currency to meet their external obligations. Both these factors put downward pressure on the rupee.

b) **Trade Channel:** The effects of the crisis in the real sector of the Indian economy were transmitted through the external trade channels, that is, exports and imports. Although India’s exports are a relatively small fraction of the GDP (15.1% in 2008-09), it had been growing steadily since 2004-05 (Table 2). The two-way trade (sum of exports and imports) as a fraction of the GDP was about 34% in 2008-09. The impact through Trade Channel will be discussed in next section.

c) **Confidence Channel:** The third channel through which the financial crisis spread to the Indian economy is through the confidence channel. Consumers, investors and businesses became more risk averse and cut back on their consumption and investment. Mishra (2009) reports that banks became more cautious about lending to borrowers in 2008-09 and credit growth declined to 17.3% from 22.3% in the previous year. Gupta (2009) documents decline in employment in several industries and in wage earnings of the labor force. The pessimistic sentiment of businesses, consumers and investors were reflected by the 41% decline in the National Council of Applied and Economic Research (NCAER) Business Confidence Index in January 2009, compared to the previous year.

4. **IMPACT OF CRISIS ON EXPORTS**

Since liberalization, there is increase in the India’s international trade and its contribution to GDP is also rising. But with the crisis India’s exports started to fall at the end of 2008. The reason behind the decrease in the trade during the Great recession can be the increased income elasticity of world trade which has risen from around 2 in the 1960’s to around 4 in 2008 (Freund 2009). This increased elasticity of world trade is due to globalization. Trade finance is the other major factor that has caused the fall in world trade. The United Nations Conference on Trade and Development (UNCTAD) has identified three visible attribute of economic slowdown that have a direct impact on international trade (UNCTAD 2009). First is
the economic effect which causes exports to the country experiencing slowdown to fall due to decrease in the demand. Second is supply chain effect, with the globalization there is internationalization of the supply chain and when one link in this supply chain is disrupted, the whole chain collapses. Third is the financial squeeze as recession leads to the tighter financial conditions that persist in all the sectors of the economy. Even the exporters were worried that the debt crisis in the western world will hit demand and lead to a payment problem.

In recent decades the financial markets have become increasingly globalized. Earlier it was believed by the researchers that the recession will not affect India. But the contagious effect of global recession started to strain Indian Economy in early 2008 and eventually full impact on Indian economy was felt towards the end of 2008. In 2006 India’s total merchandise exports were Rs 571779.3 crore which recorded 25.27% growth. But when recession enters into US India’s exports rises up to 655863.5 (14.70% growth) and in 2008-09 it achieved 28.19% growth. In 2009-10 growth of exports was just 0.56%. In figure 1 we can see the impact of recession on exports and imports of India. As a result of crisis in USA, the exports from India started experiencing negative growth in October 2008 which remained in negative territory till Quarter ending September 2009. The export growth has deteriorated from a peak rate of about 43 percent in Q1 of 2008-09 to -9.1 percent in Q3 and further to -24.2 percent in Q4 – a contraction for the first time since 2001-02. The export growth has further deteriorated to -32.5% in Q1 of 2009-10 and remained negative in Q2 at -21.0%.

**Figure -1:** Monthly Growth Rates of Exports and Imports: India

![Monthly Growth Rates of Exports and Imports: India](image)

**Source:** Reserve Bank of India
A careful look at Figure-2 reveals that during the period though the exports growth rate has declined considerably but the trade surplus have improved. This may be due to the decline in world energy and commodity prices and to both countries’ shrinking internal demand, imports have decreased much faster than exports, causing a surge in the trade surplus.

### 4.1. Direction of Exports

[Figure 2: Major Export Destinations of India]

India has trading relations with all the major trading blocks and geographical regions of the world. Figure 2 shows the major destinations of exports of India (% share of exports). Here we have selected the major ten importing countries of India in 2007. We can see that US and UK’s share in Indian exports has fallen over time. This decrease can be considered an aftermath of the financial crisis.

One of the core reasons for the sharp fall in India’s exports is the high income demand elasticity for exports which makes exports highly sensitive to GDP movement. India’s exports have been found to be more sensitive to income. The income elasticity of demand for India’s exports has been found to be highest for the US (2.5) while, for India’s global exports, it is estimated at about 1.9 (UNCTAD 2009).
Table-1: Regional Distribution of Exports from India

<table>
<thead>
<tr>
<th>Region</th>
<th>2006-07</th>
<th>2007-08</th>
<th>2008-09</th>
<th>2009-10</th>
<th>2010-11</th>
</tr>
</thead>
<tbody>
<tr>
<td>OECD</td>
<td>41.99</td>
<td>39.45</td>
<td>37.45</td>
<td>35.99</td>
<td>33.30</td>
</tr>
<tr>
<td>EU</td>
<td>21.21</td>
<td>21.17</td>
<td>21.32</td>
<td>20.16</td>
<td>18.43</td>
</tr>
<tr>
<td>North America</td>
<td>15.81</td>
<td>13.48</td>
<td>12.22</td>
<td>11.56</td>
<td>10.61</td>
</tr>
<tr>
<td>Asia and Oceania</td>
<td>3.40</td>
<td>3.17</td>
<td>2.53</td>
<td>2.95</td>
<td>2.80</td>
</tr>
<tr>
<td>Eastern Europe</td>
<td>1.23</td>
<td>1.13</td>
<td>1.10</td>
<td>1.01</td>
<td>1.17</td>
</tr>
<tr>
<td>Developing countries</td>
<td>39.90</td>
<td>42.46</td>
<td>37.50</td>
<td>39.33</td>
<td>41.60</td>
</tr>
<tr>
<td>Asia</td>
<td>29.77</td>
<td>31.60</td>
<td>28.04</td>
<td>29.87</td>
<td>30.92</td>
</tr>
<tr>
<td>SAARC</td>
<td>5.12</td>
<td>5.90</td>
<td>4.62</td>
<td>4.69</td>
<td>5.00</td>
</tr>
<tr>
<td>other Asian Dev. Countries</td>
<td>24.65</td>
<td>25.70</td>
<td>23.42</td>
<td>25.19</td>
<td>25.92</td>
</tr>
<tr>
<td>Africa</td>
<td>6.87</td>
<td>7.51</td>
<td>6.33</td>
<td>5.85</td>
<td>6.55</td>
</tr>
</tbody>
</table>

Source: Reserve Bank of India

In table-1 we can see the share of Region in India’s Exports. Here we can see that the share of OECD has declined since 2007-08 in exports and the slowdown in developing countries is found only in the year 2008-09. It can be concluded that there is a shift in the direction of exports from the Organization for Economic Cooperation countries and Russia to the developing countries. The share of developing countries went upto 41.60 percent in 2010-11 from 37.50% in 2007-08. with in the developing countries share of Asia decreased in 2008-09 upto 28.04% and again increased 30.92% in 2010-11. Overall share of exports of all the countries got affected in the year 2008-09 except OPEC countries.

4.2. Composition of Exports

In 2006-07 major export commodities included engineering goods, petroleum products, chemicals and pharmaceuticals, gems and jewellery, textiles and garments agricultural products, iron ore and other minerals. Table-2 shows the change in the composition of exports.

Table-2. Change in the Composition of Exports(%share)

<table>
<thead>
<tr>
<th>Commodities</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ores &amp; Minerals</td>
<td>3.71</td>
<td>6.08</td>
<td>5.98</td>
<td>5.54</td>
<td>5.60</td>
<td>4.27</td>
<td>4.86</td>
<td>4.20</td>
</tr>
<tr>
<td>Leather &amp; Manufactures</td>
<td>3.39</td>
<td>2.90</td>
<td>2.62</td>
<td>2.39</td>
<td>2.15</td>
<td>1.95</td>
<td>1.89</td>
<td>1.49</td>
</tr>
<tr>
<td>Engineering Goods</td>
<td>19.43</td>
<td>20.77</td>
<td>21.07</td>
<td>23.40</td>
<td>22.94</td>
<td>25.87</td>
<td>21.47</td>
<td>27.08</td>
</tr>
<tr>
<td>Textile &amp; Textile Products</td>
<td>20.04</td>
<td>16.23</td>
<td>15.91</td>
<td>13.75</td>
<td>11.92</td>
<td>10.95</td>
<td>11.14</td>
<td>9.18</td>
</tr>
<tr>
<td></td>
<td>16.56</td>
<td>16.47</td>
<td>15.06</td>
<td>12.64</td>
<td>12.08</td>
<td>15.29</td>
<td>16.27</td>
<td>16.06</td>
</tr>
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<td>----------------------</td>
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<td>-------</td>
<td>-------</td>
<td>-------</td>
<td>-------</td>
<td>-------</td>
</tr>
<tr>
<td>Gems &amp; Jewellery</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Handicrafts</td>
<td>0.78</td>
<td>0.45</td>
<td>0.45</td>
<td>0.35</td>
<td>0.31</td>
<td>0.16</td>
<td>0.13</td>
<td>0.09</td>
</tr>
<tr>
<td>Petroleum Products</td>
<td>5.59</td>
<td>8.37</td>
<td>11.29</td>
<td>14.78</td>
<td>17.41</td>
<td>14.68</td>
<td>15.72</td>
<td>16.48</td>
</tr>
<tr>
<td>Miscellaneous Products</td>
<td>3.9</td>
<td>3.69</td>
<td>3.38</td>
<td>3.39</td>
<td>3.27</td>
<td>4.82</td>
<td>5.72</td>
<td>4.29</td>
</tr>
</tbody>
</table>

**Source:** RBI Handbook

Exports as a whole experienced significant contraction during the period of crisis. Agriculture, ores & minerals, textiles, leather & chemicals have witnessed a stagnant or declining percentage share in the total basket of goods, whereas gems & jewelers, engineering & electronic goods have shown a healthy growth rate and an increased percentage share in the exports. This shows the structural change in the Indian exports base.

**5. FISCAL MEASURES**

The government has supplemented the monetary measure to stimulate demand with various fiscal measures. On fiscal policy, the focus can be divided into two parts, the expenditure part and tax exemption part (concentrated in three packages between December 2008 and February 2009.) The major highlights of these measures are as explained.

**Plan Expenditure:** In first stimulus package (7th December, 2007), the government has augmented plan expenditure by additional Rs. 20,000 crore in 2008-09, mainly for critical rural, infrastructure and for various social security schemes.

**Measures to Support Exports:** A 2% interest rate subvention up to March 31, 2009 in pre-and post-shipment credit for labour-intensive exports was made subject to minimum rate of interest of 7 percent per annum. Additional funds of Rs. 1100 crore was also made to ensure full refund of Terminal Excise duty/CST. An additional allocation of Rs. 350 crore was also made for export incentive schemes. ECGC was also provided back-up guarantee of Rs. 350 crore to enable it to provide guarantees for exports to difficult markets/products. The Exporters were allowed refund of service tax on foreign agent commissions of up to 10 percent of FOB value of exports. The exporters were also be allowed refund of service tax on output services while availing of benefits under Duty Drawback Scheme. In third stimulus package on 26th February 2009, the government has decided that to issue Duty Credit Scrips under Duty Entitlement Pass Book (DEPB) Scheme without waiting for realization of export proceeds and procedures for claiming Duty Drawback refund & refund of Terminal Excise Duty further simplified. A special Package of Rs. 325 crores was provided for Leather and Textiles sector.

**Infrastructure Financing:** In order to support financing of Public Private
Partnership projects, Government has authorised the India Infrastructure Finance Company Limited (IIFCL) to raise Rs. 10,000 crore through tax-free bonds by 31st March 2009. These funds were used by IIFCL to refinance bank lending of longer maturity to eligible infrastructure projects, particularly in highways and port sectors. In particular, these initiatives were meant to augment a PPP programme of Rs. 100,000 crore in the highways sector.

**Taxation Measures:** The government has announced across-the-board cut of 4 percent in ad-valorem Central value-added tax (CENVAT) rate except for petroleum products. To give relief to service sectors, Service Tax Rates were reduced by 2%, from 12% to 10%. To boost the demand for colour television sets, washing machines, refrigerators, air-conditioners, soaps, detergents, hybrid cars and commercial vehicles etc., Central Excise Rate was also reduced from 10% to 8%. The Government also slashed excise duty on bulk cement by 2%.

**Other Measures:** GOI has extended the flexibility to states to deviate from fiscal consolidation targets by 0.5% beyond March 31, 2009, to boost infrastructure and enable them to generate more employment. State government will be allowed to raise additional market borrowings of 0.5 percent of their gross state domestic product (GSDP), amounting to about Rs 30,000 crore, for capital expenditures in the current year.

### 6. CONCLUSIONS

Indian economy has been hurt by the global financial recession. As a result of crisis in USA, the exports from India started experiencing negative growth in October 2008 which remained in negative territory till Quarter ending September 2009. The export growth has deteriorated from a peak rate of about 43 percent in Q1 of 2008-09 to -9.1 percent in Q3 and further to -24.2 percent in Q4 – a contraction for the first time since 2001-02. The export growth has further deteriorated to -32.5% in Q1 of 2009-10 and remained negative in Q2 at -21.0%. the share of OECD has declined since 2007-08 in exports and the slowdown in developing countries is found only in the year 2008-09. It can be concluded that there is a shift in the direction of exports from the Organization for Economic Cooperation countries and Russia to the developing countries. Exports as a whole experienced significant contraction during the period of crisis. Agriculture, ores & minerals, textiles, leather & chemicals have witnessed a stagnant or declining percentage share in the total basket of goods, whereas gems & jewelers, engineering & electronic goods have shown a healthy growth rate and an increased percentage share in the exports. This shows the structural change in the Indian exports base.
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