

EXTERNAL SECTOR VULNERABILITIES AND ITS IMPACT ON THE INDIAN ECONOMY

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ABSTRACT

The aim of this paper is to discuss about the various external sector vulnerabilities that can affect India and the extent of the impact which they can make on the Indian economy. With globalisation leading the process of economic development, all the economies are linked to each other either directly or indirectly. Thus, any crisis or a recession in one country can affect many countries by network effects. This paper talks about four such events which can have an impact on the Indian economy. The paper tries to talk about the positive as well as the negative effects of these events on various sectors of the Indian economy.

Keywords: External sector vulnerabilities, Economic development, Indian economy

INTRODUCTION

The external sector of an economy is that portion which interacts with the economies of other countries. It takes into account all the trade, investment and borrowing transactions undertaken by a country with other countries. External sector plays a crucial role in the economic expansion of a country.

When India gained independence in 1947, its main aim was to become self sufficient and rely less on the external sector focusing primarily on the basic and consumer industries. Thus, import substitution constituted a major part of India's trade and industrial policies. The planners never thought that foreign trade could be an option to stimulate the economic growth. The primary reason behind this was that the planners never believed that India had the potential to boost its economic growth by improving its export earnings. The second 5 year plan introduced by Mahalanobis focused on the heavy industry sector as it was believed that by importing capital and setting up heavy industries, we will be in a state to produce all the basic as well as industrial commodities. However, the plan was unable to succeed due to various weaknesses and challenges faced by the Indian economy at that time. This also led to a 'technological lag' and

resulted in poor export performance. Until the end of 1970, import substitution over a wide area of production remained the basic aim of the development strategy. The biggest change in the history of Indian economy happened in 1991 with the coming in of the LPG. It brought down various restrictions on imports. Except consumer goods, almost all capital and intermediate goods could be freely imported subject to tariffs.

Another important change occurred with respect to the exchange rate regime. It was known that the 1991 crisis was triggered by a severe balance of payments problem. The rupee was devalued in 1991 but the major transformation came in March 1992 where a dual exchange rate regime was introduced. However, within a short period of one year i.e. in March 1993, India moved to a single market determined exchange rate system. This system did not allow for any interventions by the central bank. Also, a major change was brought in with respect to financing of the current account deficit. Prior to 1991, current account deficit was financed by multilateral and bilateral assistance, external commercial borrowings and NRI deposits. However, after 1991, the restrictions on the foreign direct investment and the portfolio investment were eased and India experienced a huge capital inflow. The foreign direct investment is now permitted in a number of sectors where the foreign ownership can be as high as 100 percent. With respect to portfolio investment, the regulators recognize certain institutions as authorized Financial Institutional Investors (FIIs) and permit them to invest in the Indian stock market. Thus the new trade regime combined with changed in the exchange rate regime and the flow of capital has completely changed the shape of India's external sector. It can be claimed that India's balance of payments has never been as comfortable as it has been since 1992-93 except for short hiccups in 2008 and 2013.

As stated by 'The 2017 External Sector Report' by the IMF, the major risks to the Indian economy stem from the global financial volatility. It further said that relying majorly on debt financing and portfolio inflows would create significant external sector vulnerabilities. The report said that the monetary policy framework has been strengthened but further supply side reforms and continued fiscal consolidation are the key requirements to achieve a low and stable rate of inflation in the medium term. According to the report, the external sector position in 2016/17 is broadly consistent with medium—term fundamentals and desirable policy settings.

This paper talks about four such events which have the greatest possibility of leaving a major impact on the Indian economy. The paper is divided into four sections. The first section talks about the effects of Brexit on the Indian economy. The second section analyzes the impact of the slowdown of the China's economy on different sectors of the Indian economy. The third section discusses the continuous hike in the fed rate in US. The Greek depression and its impact has been discussed in the fourth section of this paper.

1. Brexit

British withdrawal from the European Union which is often shortened to Brexit is a political goal that was pursued by various individuals, advocacy groups, and political parties since the United Kingdom (UK) joined the precursor of the European Union (EU) in 1973. The result of this referendum held in June 2016 was 51.9% in support of an exit (17,410,742 votes) and 48.1% (16,141,241 votes) to remain with a turnout of 72.2% and 26,033 rejected ballots.

Britain has had a troubled relationship with European Union since the beginning and has made various attempts to break away from it. Brexit supporters say that Britain is losing a big deal by staying in the Union as it has to pay millions of pounds each week as contribution to the European Budget; extremely bureaucratic nature of European Parliament is hurting British exporters and finally, that unmitigated migration from the Union countries into Britain is creating an imbalance in welfare schemes of UK government. However, experts say that British gains more from European Union than it pays as contribution; despite bureaucratic hurdles, British companies have unfettered access to entire EU and finally Britain would not be able to shut its doors to immigrants even if it exits EU because to trade with bloc, it needs to accept some share of outsiders.

Brexit's impact on India comes as a mixed bag. The leave campaign hasn't mapped out the future course. There is no sound plan about Britain's future relationships with EU countries. There is no information if they will still be able to access the EU markets or will there be trade barriers. But with Brexit, global financial market volatility is readily expected. Markets across the world will tank, pound will depreciate against major economies and India cannot remain immune to this. Sensex in Nifty will fall in short run because foreign investors would try to hedge their losses by sell offs in emerging markets. Also, there will be a shift in strategy as people will prefer to invest more in safer havens like gold. Also, in the short run, there will be a flight of capital from Britain which will in turn strengthen dollar and lead to depreciation of rupee. A weaker rupee may erode the returns for the foreign investors and they might pull cash out of domestic markets. Thus we can say that Brexit will impact the capital flows to india which will further depreciate the rupee.

In 2016, India-UK bilateral trade was worth \$14.02 billion of which India exported goods and services worth \$8.83 billion which imports from UK were at \$5.19 billion. Brexit won't significantly impact India's trade. The two-way trade with UK has been fairly stable since end of the last decade. Britain would desperately need new trading partner and a source of capital and labour. India fits this gap perfectly as India has a large English speaking population. Also, as migration from EU will be dried, Britain would be able to accommodate migration from other countries which suits India. EU has always wanted to develop India as a strong trade and

strategic partner and with Brexit would surely increase it. Also, Europe needs to counterbalance US and China geopolitically and also need to hedge against slowing China for its economic interest. Thus, Europe would be looking forward to work with the fastest growing major economy in the world and quickly resolve the pending trade issues with India.

Over 800 Indian companies employing more than 100,000 people are working in UK. Tata Group has massive operations in UK. Jaguar Land Rover, Britain's largest car maker would be hit by losses. The annual fall in profit of the carmaker is estimated to drop by around \$1.47 billion in the next 10 years. Also, UK has been a gateway for Indian companies to enter Europe. Thus, with Brexit, India loses its gateway. Indian companies would be forced to forge ties with other countries within EU which would get good results in the long run. India is trying to build trade negotiations with France, Netherland, Germany, etc. IT companies get 6-18% of their revenues from UK. After losing their gateway, they may have to establish separate headquarters/operations for EU leading to disinvestment from UK and diversion to EU.

India is the second biggest source of FDI for Great Britain and Britain is the third largest investor in India after Mauritius and Singapore. Brexit would lead to uncertainty with Europe and can open up FDI opportunities for India. Also, Indian companies set up markets in UK to sell products to Europe under the European free market system. With Brexit, Britain will not be as attractive a destination for Indian FDI and Netherland may become the top FDI destination. But Britain does not want to lose money from India. Thus, it may try to woo Indian companies to invest there by providing bigger incentives like tax breaks, lesser regulation and other financial incentives. Indian companies can expect a deregulated and freer market in Britain.

UK has been a famous destination for the Indian Students. UK has been providing subsidized rate of education for students from UK and EU. However, with Brexit, students from EU will not be getting this benefit. Thus, Britain will have free funds for students from other countries and thus more Indian students might be able to get scholarships. Also, as migration from EU countries stop, Britain might be able to accommodate more Indian students. Lastly, with depreciation of the rupee due to the foreign fund outflow and the rise in dollar, the petrol and diesel prices are expected to increase. Government may then want to reduce the additional excise duty imposed on fuel. Price of gold and electronic goods is expected to increase.

However, damage by Brexit will not be permanent. Thus, as even Britain stands to suffer from leaving EU in terms of the reduced trade and the sustained drop in GDP, net effect can turn out to be positive for India with trade negotiations with EU falling in place and stronger trade terms with UK.

2. Slowdown in China's Economic Growth

After three decades of double-digit growth, China started slowing as it was rebalancing its economy from export-driven to less-volatile domestic consumption driven economy. China's share in global GDP tripled from 3.6% in 2000 to 15.5% in 2015 as it grew at a breakneck speed for three decades. However, recently, China's GDP growth slowed, from nearly 10% annual growth rate observed in last three decades after it started its reforms in 1979, to a more sustainable 6.8% y-o-y in 2015 -lowest in 25 years. As China slows down and its growth model shifts from industry-led towards more services-based growth, the demand for commodities, both metal and oil, has softened. So, a slowdown in Chinese economy has led to a sharp fall in commodity prices. China's manufacturing index is declining i.e. manufacturing sector is not only slowing down but moreover it is contracting. China is suffering from overcapacity problem mainly due to excessive level of investment which is about 50% of GDP. In 2008, China brought new labour laws which increased the wages of the labourers. Thus, the labour was now costly; the cost of the product increased and the product was no longer competitive. Also, the workers in China are not skilled. China had a trend, the firms entered an industry, exploited all the resources and took all benefits possible and then moved to the next industry. Thus, as the workers had to shift their industries, they were not specialised in one field and thus not skilled. All this led to a fall in the number of exports from China. Also, the deflation of the real estate bubble is the major reason of slowdown in the Chinese economy.

China is the largest trading partner of India in terms of goods. China accounts for almost a tenth of India's merchandise trade and which are mostly imports. Imports from China accounted for around 13.5% of India's total import bill in 2014-15 while exports to China accounted for only 3.9% of total export earnings. The central bank of China has devalued their currency which has made their products cheaper and India's products expensive which creates excess capacities. With a slowdown in the Chinese markets, exports from China might decrease. A fall in the demand for Chinese products would decrease China's raw material requirement and in turn decrease India's export bill. Thus, India will not be able to take advantage of Yuan devaluation to earn dollars. India's exports to China have decreased by 19.5% to \$11.9 billion in 2014-15 from \$14.8 billion a year ago. On the other hand India's import increased by 18.4% from \$51 billion to \$60 billion in 2014-15. Its trade deficit with China has reached an unsustainable level of \$48.5 billion in FY 2014-15.

1% reduction in China's growth lowers the price of coal, metals, oil and gas. This becomes indirect risk for India as it poses a risk to significant investment made by firms in metals, mining and oil exploration sectors. Also, India's export basket to China consists of primarily resource

based products including chemicals, raw cotton, petroleum products and spices. Considering slowdown in Chinese growth rate, the demand for such products may decline.

China has been slow in investing in India. Its cumulative investment by end 2014 stood at mere \$500 million over a period of 14 years, even less that invested by Poland, Malaysia or Canada. There are many reasons for low FDI flows from China to India. First, the political trust deficit between the two countries, with some Chinese companies under government scanner, has hampered easy flow of investments from China. Second, Chinese investment in other countries has been traditionally focused on acquiring natural resources to boost its economic growth– like its investment in oil, natural gas and coal sectors in Africa, Australia, Indonesia etc. These investments have been a part of China’s strategic priority. India, being a major importer of these resources, did not attract Chinese investments. Third, China has been slow in recognising the importance of India’s market while India too has been slow in attracting Chinese investors. Fourth, the Chinese firms do not have the adequate support networks required.

The slowdown in China has resulted in a sharp fall in commodity prices. India, being the major importer of oil and other minerals, has benefited from softer oil and commodity prices. First, lower oil price has helped in reducing India’s import bill that narrowed the trade deficit. This has brought the current account deficit much lower than sustainable level of 2.5% reducing external vulnerability. Second, fiscal deficit target of 3.9% of GDP for FY 2015-16 will be met as lower oil prices have reduced the oil subsidy payment and higher excise duties on petrol and diesel have significantly increased indirect tax collection that will more than offset any shortfalls in direct tax and disinvestment target. Third, lower commodity prices helped bring retail inflation (CPI) within the RBI target of 6% by March 2016. Thus, softer commodity prices have helped improve macro stability of India. Fourth, lower raw material and oil price helped corporate to improve their profit margins.

China’s slowdown affects the global growth as China is a \$10 trillion economy. As the global growth suffers, India’s growth will also suffer as it is closely integrated in the global economy. However, China’s changing priorities may see India emerge as an alternative export hub for some products due to lower labour costs and its eagerness to become a hub for export of goods.

3. Hike in US’s Fed Rate

On 16th December 2015, US central bank raised interest rate by a quarter basis points and pledged a gradual pace of increase in interest rate. Increase in interest rate shows that the economic condition of USA is improving. Since the 2008 financial crisis, the Fed had kept the interest rate near zero. It was for the first time after seven years that Fed has decided to increase the interest rates. 0 interest rates meant poor returns for the investor. Thus the domestic as well

as foreign investor stopped investing in the US and went to the emerging markets to get more returns. Now this decision from the Fed to increase the interest rate would attract back the investors into the market. There will be a massive outflow of money as investors would shift their portfolios.

A rise in interest rate by the Fed is an indication that US is in good shape. This would attract the investors to pull their money out from India and move back to invest in US because money flows where returns are high. Also, US is the safest market for investors. Thus, people pull out money by disposing risky assets leading to a sudden outflow of money which causes mismatched in the currency position and Rupee depreciates. Looking it the other way, better returns by US would attract investments. This would increase the demand for Dollars which would strengthen the Dollar. A stronger Dollar would weaken the Rupee. However, in order to control the Rupee from falling much, RBI has been selling foreign exchange which has led to a decline in the exchange reserves by a cumulative \$3.16 billion. India's huge foreign exchange reserves act as a cushion and help in stabilizing the exchange rates.

A weaker rupee affects the trade balance as well. With dollar being stronger, our import bills rise as imports become expensive while our products become cheaper for others and so our exports rise. Thus, first order effect will likely result in an improvement in the balance of trade for India. US Fed confidence is also beneficial for the domestic IT companies as exports from India might improve. An increase in the import bills with imports being more costly may also lead to higher levels of inflation in the economy. This is because an increase in imports shows a general rise in the level of spending which puts inflationary pressure on the economy.

The Fed rate has also affected in the Indian equity market. The investors invest where the returns are higher. Thus, with a rise in the interest rates, there has been a change in the investor's portfolio. Also, as rupee depreciates, it wipes out the profits for the foreign investors. However, Indian markets may not react much as India's 7% growth rate is modest enough and can attract interest of global investors. Volatility and market swings are expected but not much turbulence this time. In fact, Indian markets may react positively as current macroeconomic situation is robust enough to propel confidence among investors. However, the start-ups in India might be affected. As returns in US increase, the global equity firms and venture capital firms who were investing in Indian start ups will likely be less interested now in the Indian start-up eco system.

But, India is better placed than most of its peers. India's external balances have improved; foreign exchange reserves are rising and acting as a cushion against exchange rate problems and; current account deficit is narrowing. India is less dependent than several of its peers on commodity exports and has thus not been negatively affected by the global rout in commodity

prices. India has been the fastest major growing economy and thus still remains attractive for the investors.

4. Greek Depression

The Greek depression is also known as the sovereign debt crisis faced by Greece in the aftermath of the financial crisis of 2007–08. After the Wall Street imploded in 2008, Greece had announced in October 2009 that it had been understating its deficit figures for years, raising alarms about soundness of Greek finances. Suddenly, Greece shut out from borrowing in the financial markets. By spring 2010, it was veering towards bankruptcy, which threatened to set off a new financial crisis in the world. To calm it, IMF, European Central bank and European Commission issued the first of the 2 international bailout packages of more than 250 billion Euros. However, the bailout came with a lot of conditions. The lenders had imposed harsh terms requiring a deep budget cuts and steep tax rise. They also wanted Greece to overhaul the economy by streamlining the government, ending tax evasion and making Greece an easier place to do business. The problem has still not been solved. The economy has shrunk by more than a quarter by now. Unemployment rates are as high as 25%. The money which the government gets mainly goes to pay the interest on the loans. The government has a huge debt load. They have been borrowing to pay their loans and are now caught in what we call a debt trap. Now if Greece defaults and leaved the euro zone, it might create global financial shocks which might be bigger than the Lehman brothers. However, if Greece leaves the currency union which can be called as Grexit, it would not be such a catastrophe.

India will not be directly affected by the Greek crisis or its depression because it is not directly exposed to Greece in terms of trade ties. India and Greece have a negligible amount of trade. However, if euro zone is hit by the crisis due to the crisis of Greece, then India will also have to bear the consequences. India's largest trading partner is Europe. India's merchandise exports have not be in prime health in 2015-16 and a crisis in Europe will worsen the situation and might have a harsh impact on the current account. A crisis in Greece is sure to affect the European market and as the European economies slow down, their business with India will also go down. Even the outsourcing would be hampered. India's software and engineering exports would be badly hit. The crisis in Greece would hit the engineering exports as European Union is the largest destination of such shipments. A decrease in exports would increase the current account deficit. Fall in Rupee would further worsen the trade. Thus, Indian companies with exposure to Europe are worried because of weakening of euro and rupee as it would lower their export revenues and increase the costs.

If Greece fails, interest rate will increase all across the Europe as the financial health of Spain and Italy is also not good. This will badly affect the strength of Euro. A change in the strength of

Euro would force the investors to reallocate their portfolios. A rise in interest rates in Europe will result in outflow of capital from India. Grexit would lead to volatility across the debt, equity and the currency market and the portfolio investors would have to reassess their investments. Traders would also lose appetite for Indian bonds due to concerns pertaining to Greece. The investors would prefer investing in safer havens like US. This would strengthen the Dollar and depreciate Rupee. This would further deteriorate the trade patterns of India and severely affect the importing companies.

A crisis in Greece as well as in Europe might decrease the level of foreign investments in Indian stock market, in Indian Bonds and even directly into companies in India. This is because the investors holding Greek bonds will lose a lot of investment. The Greek debt is mostly held by the government and by big international agencies like IMF. Some amount of debt, however, is held by hedge funds. When losses happen to private investors, they will probably start selling other investments to get liquidity. These investments can be in India as well. Selling these would depress the world market including the Indian market. The FIIs are bullish on the Indian equity market which is mainly due to the high rate of growth of India.

Lastly, as the crisis break out in Greece followed by European market and by global markets, jobs market will face a slowdown. With slowdown in Euro markets, Indian exports would decrease. As there is lower demand of Indian goods and services, the Indian job market will be hit. Crude oil prices are expected to decrease with the fall in Euro. Gold prices are expected to increase as demand for safer havens for investors would increase.

However, there won't be any crisis in India, but economy might slow down. India is in its strongest position ever since the 2008 global financial collapse to withstand any fallout of external shocks. India's huge foreign exchange cushion provides sufficient funds to meet current account deficit. India may see a slowdown in the global economy which will impact its projected growth. However, with economy growing mainly on account of domestic demand, India is better placed to ride out the impending international slowdown. Also, the European Union is totally prepared to deal with the Greece situation as it has not come as a sudden surprise. Thus, even if Greece crisis break out, the European Union countries will not face crisis as they are already prepared to deal with the situation.

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