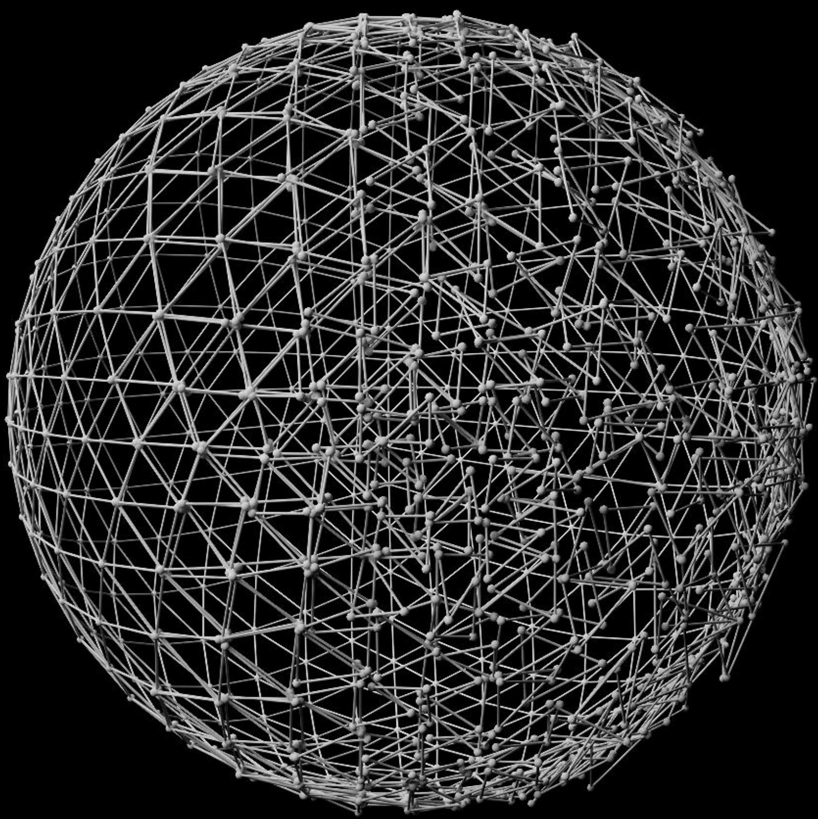


Go beyond borders to grow beyond borders

September 2021

Go beyond borders to grow beyond borders

A debate has been raging lately about whether India's recovery from the pandemic-led shock will be export and investment (backed by foreign capital) driven. For an economy whose growth has primarily been consumer-led, the recent data on exports and foreign investment has enthused many market analysts.

Average monthly exports rose from US$27.1 billion during April-July 2019 to US$33.5 billion during April-July 2021, suggesting that exports surpassed the pre-COVID levels owing to rapid economic recovery in key industrial nations with strong trade ties. The latest GDP data of Q1 FY 2021-22 confirms exports as the fastest-growth driver compared with Q1 FY 2019-20 (the pre-COVID year).

Foreign investment inflows were at a record high in FY 2020-21 and the momentum continued even in the April-June quarter of FY 2021-22. With major central banks of industrial economies rapidly expanding their balance sheets to inject liquidity and stimulate their economies from the pandemic-led downturn for over a year, global liquidity is at an all-time high (and has been rising since the 2009 global financial crisis). As bond yields were lower for a long time, many global investors turned towards emerging nations with stronger economic prospects.

In response to rising exports, the government in its recent tweet said, '…the vision for Aatmanirbhar Bharat has given a boost to exports'.

Are we getting closer to our vision of 'Make in India, Make for the world'?

Although the government has implemented several reforms and measures since the great economic liberalisation (including trade and investment) 30 years ago, the measures have had limited success in providing a better roadmap for export growth. **Exports' contribution to GDP declined since 2013, and the decline has been much more pronounced in merchandise exports compared with services** (Figure 1). At the same time, India's share in global merchandise exports remained stagnant in the past decade. That said, India's share in global commercial services exports steadily increased from 1.6 percent in 2005 to 4.1 percent in 2020.

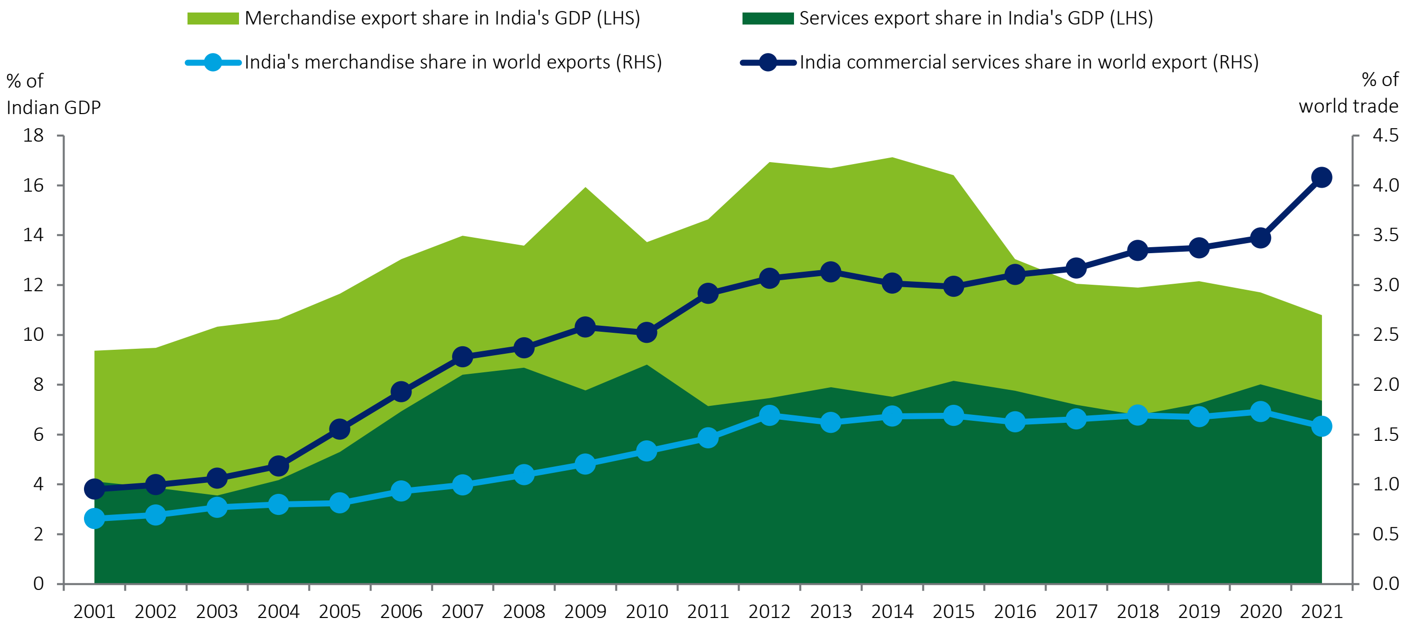
While there is a lot to celebrate about India attracting investments, a deeper dive suggests a very small proportion of the foreign investments getting utilised in capital formation. Over the past five years, net capital inflows on an average contributed about 4 percent to the total Gross Capital Formation (GCF); the contribution has been declining.[1] **A majority of the foreign investment is, therefore, being used for brownfield investments involving partnership in existing businesses or acquiring stakes with limited control over business operations.** This suggests that although foreign investors are willing to invest in India, their **appetite for risky investments is poor.** These risky and long-term investments are more productive, and create employment, assets, and income.[2]

We believe that export growth will support recovery in the short run, but that may not be sufficient to make up for the low domestic consumption (given the relatively small and falling share of external trade in India's GDP shown in Figure 1). Similarly, India must attract foreign capital investment in more greenfield projects that lead to asset and capacity creation, and transfer of technology and knowledge.

This report discusses India's integration with the world through the twin channels of trade and capital flows, policies that have enabled the integration, and measures to fire up these growth engines.

[1] Deloitte, India's FDI opportunity: Through an investor's lens - a survey report, 2021 September, https://www2.deloitte.com/in/en/pages/finance/articles/india-fdi-opportunity.html
[2] BEA database, International Trade & Investment, https://www.bea.gov/resources/learning-center/what-to-know-international-trade-investment

Figure 1: Trade in merchandise and services



Note: The data are in calendar years.
Source: IMF, World Bank, Central Statistics Office, India, Ministry of Commerce & Industry, RBI; all sourced from Haver Analytics

India's integration with the world

Amidst the opportunities emerging from globalisation and the geopolitical scenario, both trade and investments have evolved as the Indian economy integrated with the rest of the world.

Trade

In the past one-and-a-half decade, India's export and import destinations have changed. However, the change is much more pronounced for the latter (Figure 2). **India's dependence on Asia for imports has gone up considerably.**

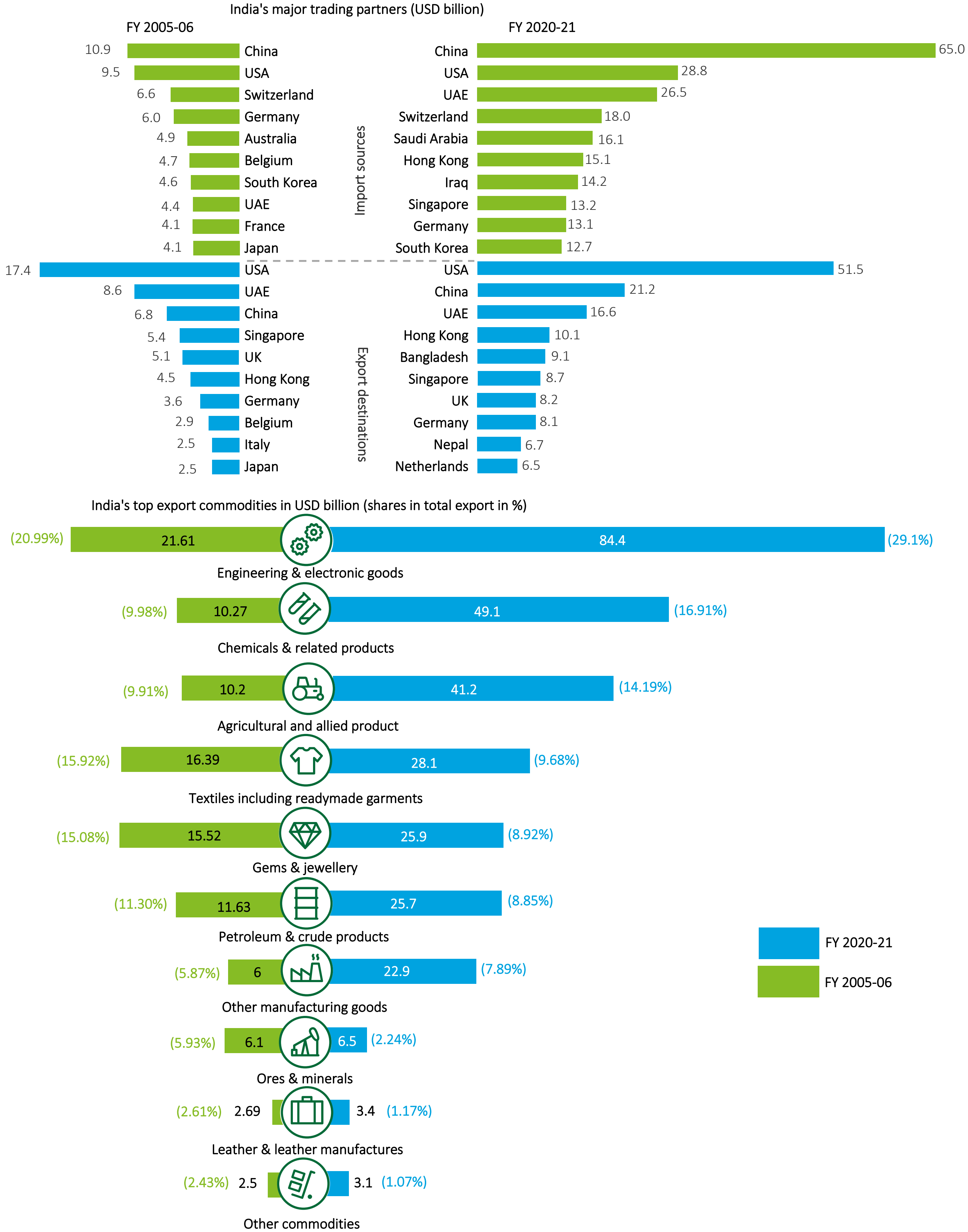
Figure 2: Trade destinations

Source: EXIM bank, sourced from CMIE

What has not changed is the geographic composition of our export destinations. The US, the UAE, and China still hold the top three positions; their combined share in total exports has gone up by 5 percent to reach 60 percent since FY 2005-06 (Figure 3).

The export basket has also changed over the years. In FY 2020-21, close to 60 percent exports comprised engineering and electronic goods (28 percent); drugs, pharmaceuticals and fine chemicals (16.9 percent); and agriculture and allied products (14.2 percent). At the same time, **sectors such as garments and leather that were given the thrust for exports in reforms and policies have lost their significance over time** (Figure 3).

Figure 3: India's trading partners and trading basket in merchandise

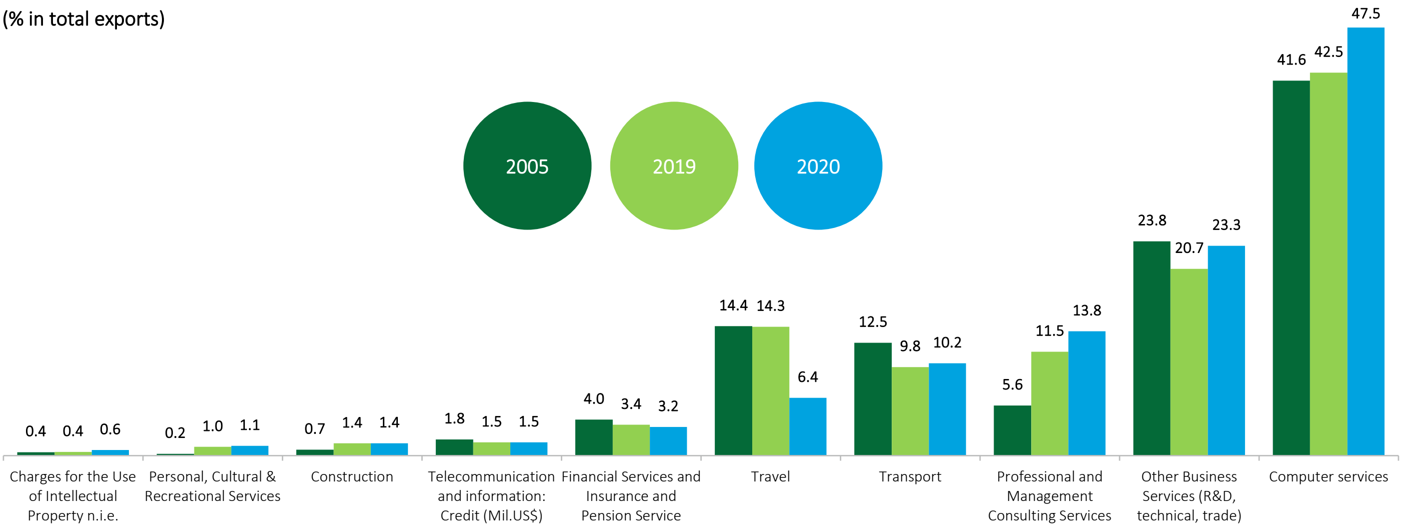


Notes: The figures in brackets are shares

Source: EXIM bank, sourced from CMIE.

Services trade has gained significance in world trade since 2005 (as seen in Figure 1). The share of services in India's total exports increased by more than 8 percent in one-and-a-half decades to 42 percent in 2020; of which, computer services accounted for 47.5 percent, and professional and management consulting services (such as Deloitte) had a 13.8 percent share (Figure 4). The contribution of financial, insurance, and pension services to total exports peaked in 2011 and has declined steadily since. The dramatic fall in the share of travel and transport services between 2019 and 2020 underlines the pandemic's unprecedented impact on these sectors.

Figure 4. Share in India's services export

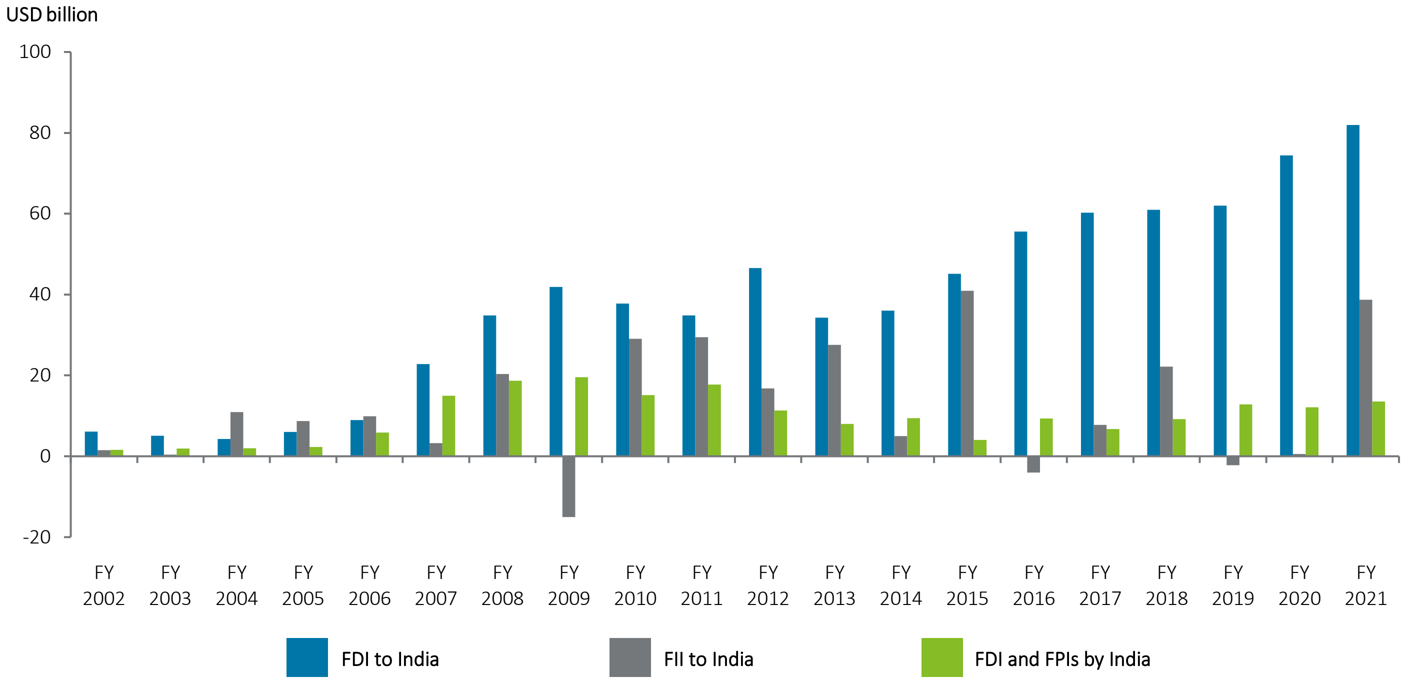


Note: The data are in calendar years.
Source: IMF, sourced from Haver analytics

Investment

India opened up gradually to foreign investments in the 1990s. However, capital inflows to India picked up after FY 2005-06 (Figure 5). So far, Foreign Direct Investment (FDI) has been the dominant form of capital inflows. Portfolio investment, particularly institutional investment (FII), has remained volatile particularly in the past decade because of high global liquidity and India's faltering economic outlook.

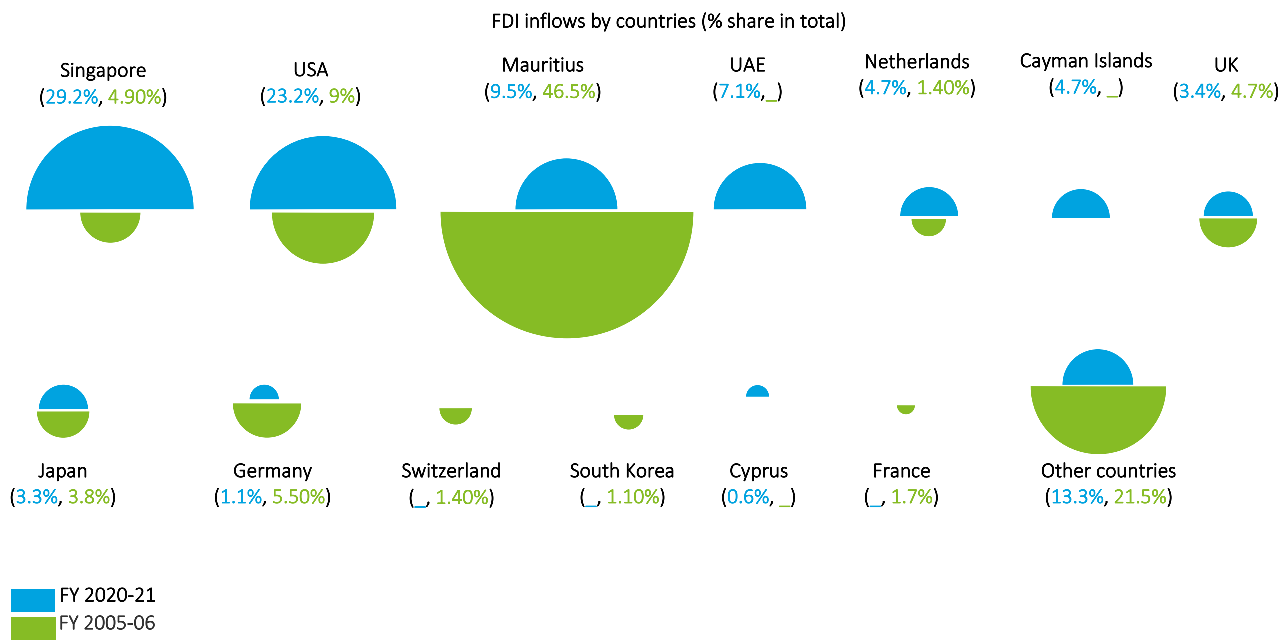
Figure 5. Capital flows



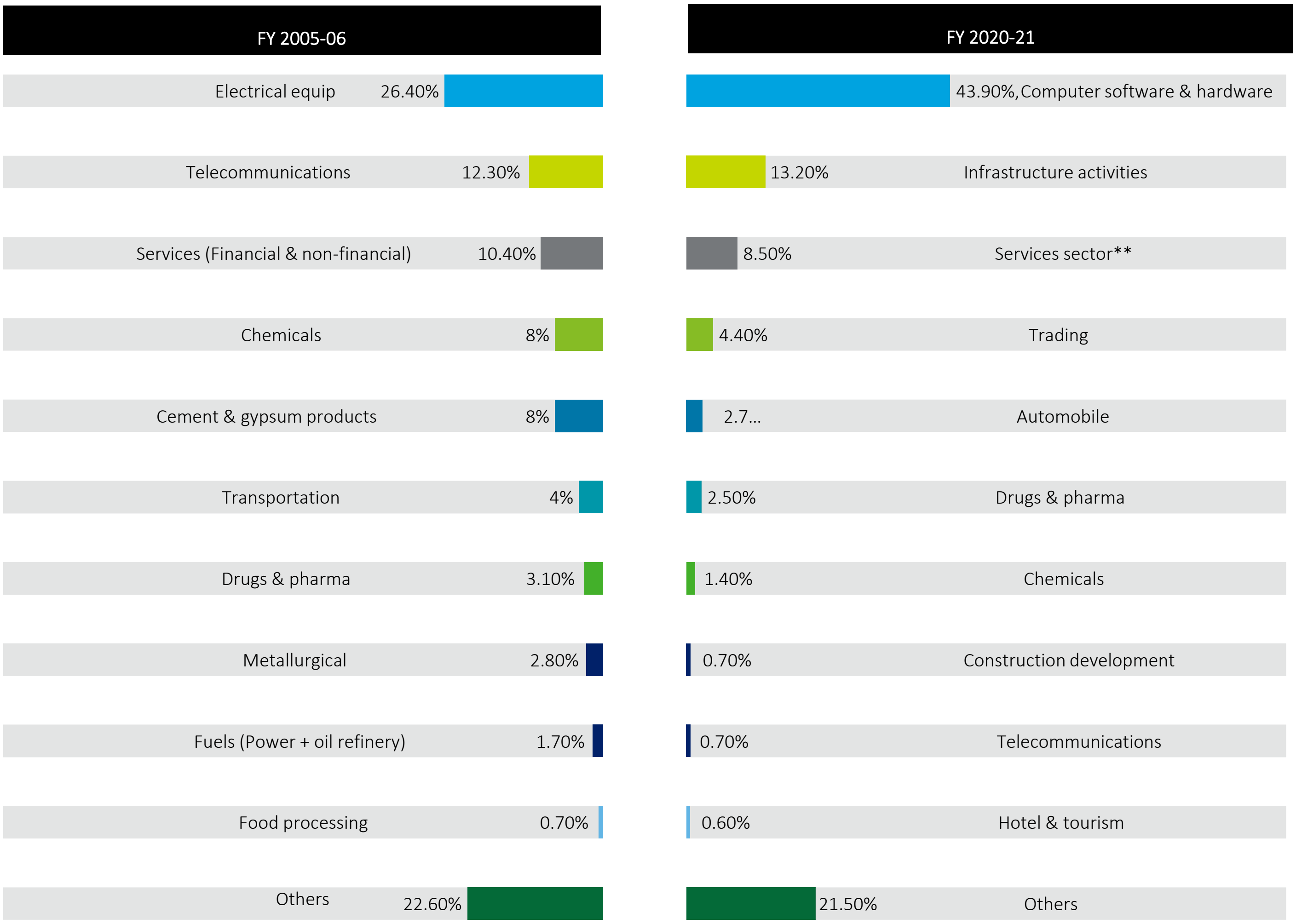
Source: CMIE

At present, Singapore and the US are the biggest investors in India, while investment from Malaysia has declined over the past one-and-a-half decades (Figure 6). Investments from the UAE and Japan have increased. **Direct investments in computer software and hardware, and transport (auto) have gone up significantly, while the manufacturing and construction sectors have lost their share in FDI.** Interestingly, investments in financial and communication services peaked just before India's non-bank financial crisis in FY 2018-19 and the economic slowdown in FY 2019-20 respectively.

Figure 6. India's FDI composition by sector and nation



FDI inflows by major sectors (% share in total)



Note: ** Services sector includes Financial, Banking, Insurance, Non-Financial / Business, Outsourcing, R&D, Courier, Tech. Testing and Analysis, Other
Source: The RBI, sourced from CMIE

The policy enablers of integration

While economic reforms and government initiatives taken since liberalisation have played an important role in boosting trade and investment, India also relied on trade agreements. India is one of the top Asian countries with the maximum number of Free Trade Agreements (FTAs) in operation or under negotiation or at a proposal stage.

However, India's recent experience with FTAs has not been encouraging. For instance, its trade deficit with several major trading partners (Japan, Korea, and ASEAN nations) has increased after signing trade agreements with these nations, suggesting a rising import dependence on them.[3] Besides, revenue foregone has more than doubled to nearly INR 26,000 crore in FY 2018-19 as a result of lower import duties that had to be implemented as part of the ASEAN-India FTA.[4] As a result, India has become sceptical of trade agreements and signed only one FTA since 2012.[5]

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[3] Durgesh K Rai, India's trade with its FTA partners: experiences, challenges and way forward, *The Economic Times*, 2019, https://economictimes.indiatimes.com/blogs/et-commentary/indias-trade-with-its-fta-partners-experiences-challenges-and-way-forward/
[4] Dr Niti Bhasin, How govt can reorient its foreign trade policy to align it with Atmanirbhar Bharat Abhiyan, *ETNOW*, https://www.timesnownews.com/business-economy/economy/article/how-govt-can-reorient-its-foreign-trade-policy-to-align-it-with-atmanirbhar-bharat-abhiyan/726374
[5] ADB database, https://aric.adb.org/database/fta

In the past few years, the government has slightly changed its lens in reshaping its integration with the world. It has undertaken several financial and non-financial measures to incentivise exports and promote India as the manufacturing hub. For instance, currently, close to 70 percent of international trade is driven by the Global Value Chain (GVC). India recognises that engaging in the value chain can help India improve profits through exports by value addition.[6] Therefore, India is aiming to increasingly engage in the global supply chain as well as move up the value chain through its Aatmanirbhar Bharat mission, accompanied by production-linked incentives for 12 sunrise sectors.

These initiatives encourage foreign investors to invest in India by introducing a raft of changes in FDI regulations and norms. Higher capital inflows will aid in providing the resources that India needs to become a part of the global supply chain despite disruptions caused by US-China trade conflicts as well as the pandemic.

Measures to enhance exports and attract investments

India needs to be quick on its feet to boost exports and direct investments in asset and job creation to lift a sagging economy. While all eyes are on the upcoming Foreign Trade Policy 2021-2026, we expect it must execute immediate measures, along with long-term efforts, to ensure a strong and sustainable recovery.

Short-term measures

One of the ways would be to streamline existing logistics and infrastructure to reduce costs. Even though variable costs for production have been low, high fixed costs associated with land and power make India less competitive relative to its peers. **India can rationalise existing infrastructure to remove bottlenecks and improve last-mile connectivity.**

Another way would be to diversify its geographical presence for its exports as well as the export basket. As mentioned earlier, India has high exposure to a handful of geographies. Therefore, it must try to deepen its trade and investment relations by creating new market destinations in other regions for its existing products, such as the East-Asian, African, and Latin American nations. For instance, **India has a competitive advantage in the services sector, and it can assist African countries in sectors such as healthcare, finance, and education. This will benefit Africa immensely.** Diversification will reduce the country’s exposure to geopolitical risks and improve exporters' reach to a wider customer base. This will motivate exporters to increase capacity and attract investment.

At the same time, **India must differentiate its export basket, including higher-value products and services that increases profitability.** Recent data suggests that there has been a shift in the trade components towards machinery, electronics, pharmaceuticals, and engineering goods. India must scale up its capacity and divert its resources towards these high-value added and profitable products. Easy, competitive, and affordable financing options will help exporters meet their funding needs to pursue capacity creation and expansion, and explore opportunities. The recent engagement of the Export-Import Bank (India Exim Bank), along with Japan Bank for International Cooperation (JBIC), with Indian pharmaceutical companies is a case in point; the two organisations collaborated to promote exports from India. Such efforts must continue with other sectors as well.[7]

Finally, through rapid digitisation, India must strengthen backward and forward linkages with the Micro, Small, and Medium Enterprises (MSME) sector and make them an important part of the manufacturing value chain (through serving global brands). **Digital facilitators (such as e-commerce, e-marketing, and e-business) can improve export practices, disseminate information, drive awareness, provide market intelligence, and expand network dynamics, amongst others, and will aid in growth for MSME exporters.**

Long-term measures

These measures have to be more focussed and premeditated to improve global confidence and maximise the potential returns of trade and investment over the next few decades. India must create industry capacity and scale to compete with its peers, engage in the global value chain, increase ease of doing business and competitiveness, and assure sustained returns to investors. For that, **India will require building a world-class infrastructure, empowering the workforce by reskilling and upskilling to prepare them for the future of work, and investing in research and development centres.**

The government’s role will be critical in achieving the above-mentioned goals. It must have a roadmap to ease regulatory and compliance hurdles as well as implement reforms associated with dispute settlement and investment protection. The focus should

[6] OECD, Global value chains and trade, https://www.oecd.org/trade/topics/global-value-chains-and-trade/
[7] IIFL securities, India Exim Bank engages with Indian Pharma companies to promote exports from the country, September 2021, https://www.indiainfoline.com/article/news-sector-others/india-exim-bank-engages-with-indian-pharma-companies-to-promote-exports-from-the-country-121090700511_1.html

also be on strengthening International Patents Rights (IPRs). IPRs foster market expansion and thereby, increase export of new products in the capital-intensive and patent-sensitive industries, such as chemicals, machinery and transport equipment, and consumer electronics. These are also the sectors that India is now focusing on for investments and exports. Empirical evidence suggests that expansion in product variety accounted for the increase in US exports between 1990 and 2000.[8] Needless to say, the government must revisit its trade agreement. It should also forge new partnerships to link trade and investment with various government initiatives and get greater market access for its traded goods and services in partner countries.

The list of measures mentioned above is, by no means, exhaustive, but imperative for increasing export and channelling foreign investments in capital formation. While consumer demand will continue to be the biggest driver for a foreseeable future, relying on consumption alone for strong and sustainable recovery might not be prudent.

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[8] Olena Ivus, Does stronger patent protection increase export variety? Evidence from US product-level data, *Journal of international business studies*, 2015, https://www.researchgate.net/publication/277966038_Does_stronger_patent_protection_increase_export_variety_Evidence_from_US_product-level_data