EXASPERATED ECONOMY & EXPORTS

Analysing the Impact of COVID-19 on Indian Exports and Global Trade

The world is only slowly picking up the pieces in the wake of the novel coronavirus (COVID-19) pandemic. There has been a significant loss of human lives and the global economy has also felt the impact severely. Global markets have seen large-scale supply-chain disruption, and manufacturing has fallen to the lowest levels in decades, with most economies only gradually returning to a semblance of normalcy. India, too, has suffered setbacks, but is now looking forward towards improvement. After witnessing a steep fall in export and PMI numbers in April and May, June has shown a promising recovery indicating the restart of economic activity. Market indices Sensex and Nifty, often touted as forward looking indicators for the health of the economy in common-speak, have recovered to almost 90% of their pre-COVID levels. Everyone is asking the same question: “Is the worst finally behind us?”

In the concluding part of this working paper series, we deliberate on the road to recovery, and highlight how this might be the opportune moment to bring in some long-awaited structural reforms to India’s export sector, through the much-awaited-but-delayed FTP.

The only way is up?

India’s merchandise exports hit rock-bottom in April 2020 at $10.3 billion, a year-on-year negative growth of -60.28%. However, since then, the sector’s state has improved every month, with the latest data for June 2020 showing that exports recovered to almost 88% levels of the numbers posted last year. According to reports, other economic indicators such as the Purchasing Managers’ Index (PMI) have also recovered from the lows they witnessed in the last few months. The markets have been displaying positive behaviour too, with a flurry of activity pushing benchmark indices like the Sensex and Nifty higher. But does this mean the worst of the COVID-wrought economic pain is behind us? Unfortunately, that seems unlikely.

The human toll of the COVID-19 pandemic continues to rise. India is now the third-worst affected country in the world, with nearly 1.4 million confirmed cases, and over 30,000 deaths (at the time of writing this paper). Also, while the pandemic’s economic impact seems to be wearing off, based on the latest statistics, a closer look at the figures reveals a different story.

Take the trade data for June 2020, for example. While India’s exports continued to post remarkable recovery from the lows of previous months, it may be premature to use this short-term recovery as indicative of a larger return to growth and/or positive sentiment. Drip Capital’s analysis of publicly available trade data shows that while the June improvement is definitely indicative of recovery in the economy, it has been driven because of fulfillment of delayed orders which had been previously pent-up due to the imposition of a lockdown by the Indian government starting March. India's shrimp exports to the US, for example, contracted by 58% suddenly in an unprecedented manner in May before rebounding in June, as a result of the lagged effect of the lockdown in late March, April, and May (the shipments usually take 30-45 days to reach the US, the biggest market for Indian shrimp). If anything, the June figures indicate that while the disruption in India's supply chain for the exports sector is being gradually rectified, the true effect of this recovery will likely be seen only in the medium- to long-term, possibly towards the last quarter of the year.

Import concerns

India also posted a trade surplus in June, for the first time in 18 years. The sharp plunge in imports has worried many analysts, as it indicates weakening demand and a slowdown in the country's manufacturing sector, which is still reliant heavily on imports of raw materials. India's PMI, while steadily improving, is still in the contractionary zone, and the prospect of rising inflation in the coming months indicates that all is not well yet. In an interview, top Indian economist and former Director of the National Institute of Public Finance and Policy Rathin Roy said, "Never draw conclusions from a single data point…ignore anyone who talks of green shoots, it's not prudent to conclude from a month's data." Clearly, India's exim sector is not out of the woods yet.

Apart from signifying weak domestic demand, India's falling imports also indicate that the country's value-added production and manufacturing sectors, such as engineering goods, have not picked up despite the slow recovery in the economy. This slower-than-expected manufacturing restart leads us to believe that overall, Indian exports can expect a somewhat W-shaped recovery of exports in the coming months (see Figure 1 below). As per our estimates, the export numbers for July and August could remain slightly depressed from June levels, as the demand across other countries remains low, similar to the case in India. However, we do expect some recovery in September and October.

Drip Capital's research and analysis indicates that the economic recovery of India's exports sector will thus likely be much shallower than most optimistic estimates. However, domestic demand continues to fall across many sectors, such as steel and engineering goods, leading many companies to shift to exports instead of domestic sales to keep up their bottom lines. This switch could offset some of the negative sentiment around export recovery, but this also raises additional concerns about the health of the Indian economy. It is clear that policy intervention by the Indian government will be unavoidable. However, the lessons of the past indicate that these interventions may need to be more nuanced and better-implemented than before.

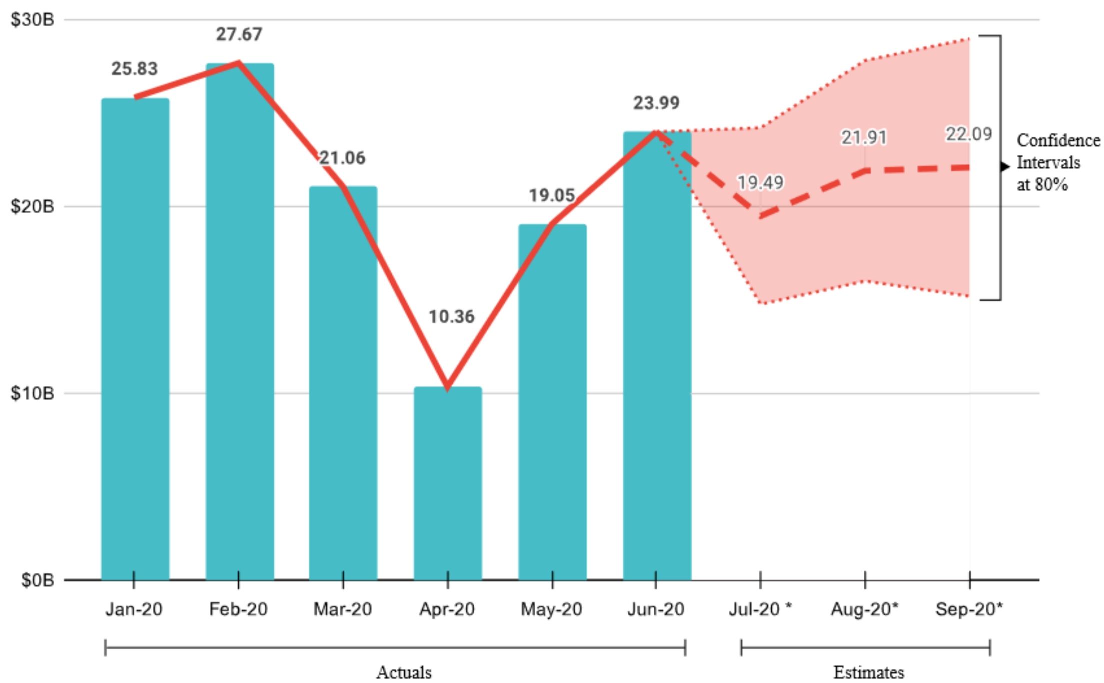

Fig 1: Indian Export Outlook Q3-2020
(Source: DGFT, Drip Capital Analysis)

Indian policy -- a crutch for the export sector?

"Nothing is so permanent as a temporary government program." - Milton Friedman

With the COVID-19 pandemic hitting the sector, if H1 2020 is any indicator, the performance of Indian exports looks set to be bleak in the coming months. We expect the year's exports to remain in the $225-275 billion range for 2020, optimistically speaking.

In a previous paper in this series, we discussed how India has been stuck in the US $300 billion rut in exports for over a decade now. While there is no doubt that COVID has resulted in major headwinds for Indian exports, their growth stagnated even before the pandemic hit us. This is an indication of structural issues plaguing the sector, particularly in the last decade. We have had two Foreign Trade Policies (FTPs) between 2010-2020 which have clearly not been able to provide the desired impetus to the export sector, although they have definitely helped keep the sector afloat.

The Indian export sector has seen significant outflows by the Indian government on various export promotion schemes and activities under the current FTP. As Figure 2 shows below, this has definitely helped India's exports maintain an upward trajectory for the most part since 2010;

however, this also begs the question if Indian exports have become too reliant on government spending to keep growing, rather than building native capabilities.

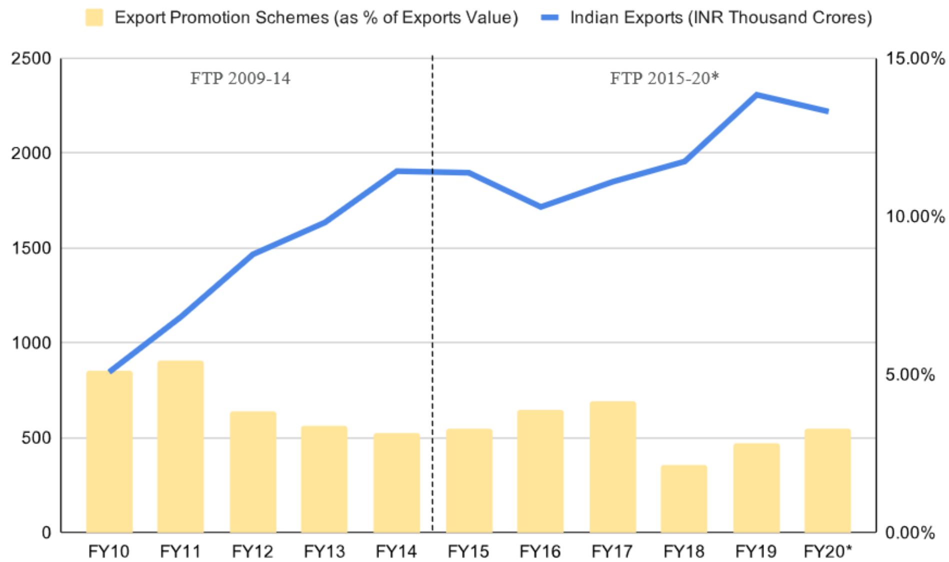

Fig. 2: Indian Exports between FY 2010-20 vs Revenue forgone by GoI under Export Promotion Schemes (Source: DGFT, Union Budget of India)[1]

A couple of other interesting observations can be noted in the above figure. One, outflows linked to export promotion schemes under both FTPs fail to keep up with the pace of rising exports, and thereby we see a drop in proportionate revenue forgone by the government in the later years of both policies. It is unclear whether this is a case of frontloading of grants for promotion of exports, or short-term-focused planning. Secondly, the data suggests that any drop in export promotion expenditure has a lagged effect, with exports correspondingly dropping in the next one to two years. This would lend further credence to the argument that Indian exports are heavily reliant on government spending to grow. While correlation may not necessarily imply causation, such patterns could be an indicator of underlying problems with the policy interventions in the export space.

The question takes on even more importance in the context of recent developments. Markets like the US and the EU have long claimed that India's export promotion schemes are unfair under World Trade Organization (WTO) standards. In October 2019, the WTO ruled that India's export subsidy schemes violated core principles of global trade norms. While the Indian government has extended the duration of these schemes, particularly the Merchandise Exports from India Scheme (MEIS), in the context of the slowdown triggered by the pandemic,

[1] Provisional estimates available for FY20.

Commerce Minister Piyush Goyal said, as long ago as June 2019, that Indian exporters need to stop depending on subsidies and government grants and focus more on building self-reliance. This is a marked departure from the rhetoric and moves of the last decade, when India's policymakers have steadfastly focused on subsidies and incentives instead of promotional schemes to shore up Indian exports, as evident in Figure 3 below. The problems faced by the Indian export sector, thus, appear to have been exacerbated by a decade-long government policy of extending subsidies rather than building self-reliance and competitiveness in the ecosystem.

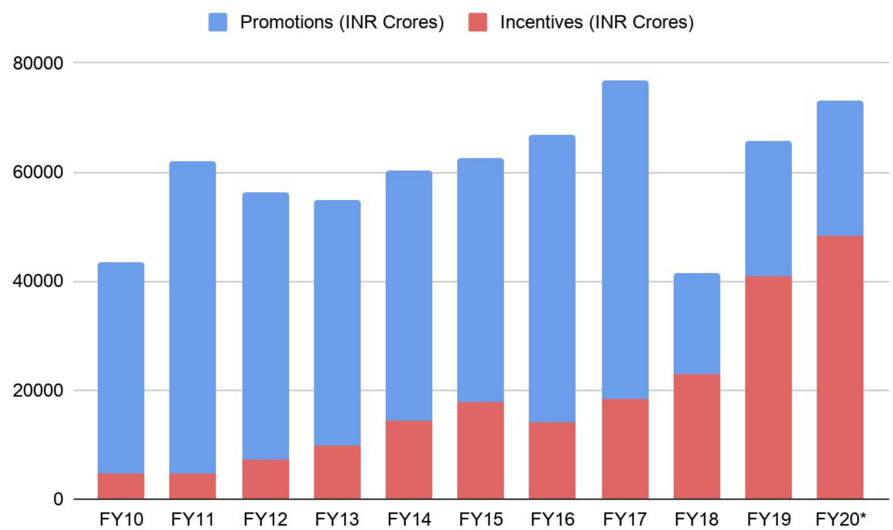

Fig. 3: Revenue forgone by GoI under Export Promotion Schemes for Incentives[2] & Promotions[3] (Source: Union Budget of India)[4]

The message of self-reliance will become even more important under the auspices of the new 'Atma Nirbhar India' movement announced by Prime Minister Narendra Modi. Therefore, Indian government policies are likely to move away from the subsidy form of assistance that the country's exporters have come to rely on, which will add to the uncertainty affecting the sector and likely cause a dip in the coming months.

With the new focus on self-reliance, one can hope that the upcoming policy will do a better job than its predecessors. The new FTP faces the unenviable task of increasing exports at the same time as moving away from subsidies. This is bound to cause some pain in the short- to medium-term, but might just turn out to be the saviour that turns arounds the fortunes of the Indian export sector in the long-term.

[2] Incentives are classified as export linked schemes such as MEIS, etc under the Receipts Budget of GoI.
[3] Promotions are classified as input tax neutralization or exemption schemes such as EPCG under the Receipts Budget of GoI.
[4] Provisional estimates available for FY 19-20.

A future of uncertainty -- and opportunity

Previous editions of our working paper have looked at the sector- and policy-level changes that need to be made to revive India's exports. A key segment that also needs a closer look and rethink is finance. RBI data suggests that a lack of export credit has plagued the sector since 2018. The Indian export space is made largely of MSMEs, who face unique challenges in accessing working capital, in part due to reluctance by traditional lenders to offer loans. As Figure 4 below demonstrates, even as exports have risen over the last decade, total outstanding export credit by Scheduled Commercial Banks (SCBs) over the same period has fallen from 30% of export value in 2010 to nearly 7% in 2020. Industry stakeholders indicate this could be because of the NPA crisis, or by the uncertainty around the upcoming implementation of BASEL-III guidelines (which has been deferred till January 2023). Whatever the cause, the fact remains that India's exporters have suffered from a significant lack of export credit from banks and other lending institutions for a while now. Collateral-free loans or credit guarantee schemes as part of the next FTP offer a solution, but a wider exercise needs to be conducted across India's finance sector to formulate trust and overhaul lending practices so that they accommodate needs of MSMEs.

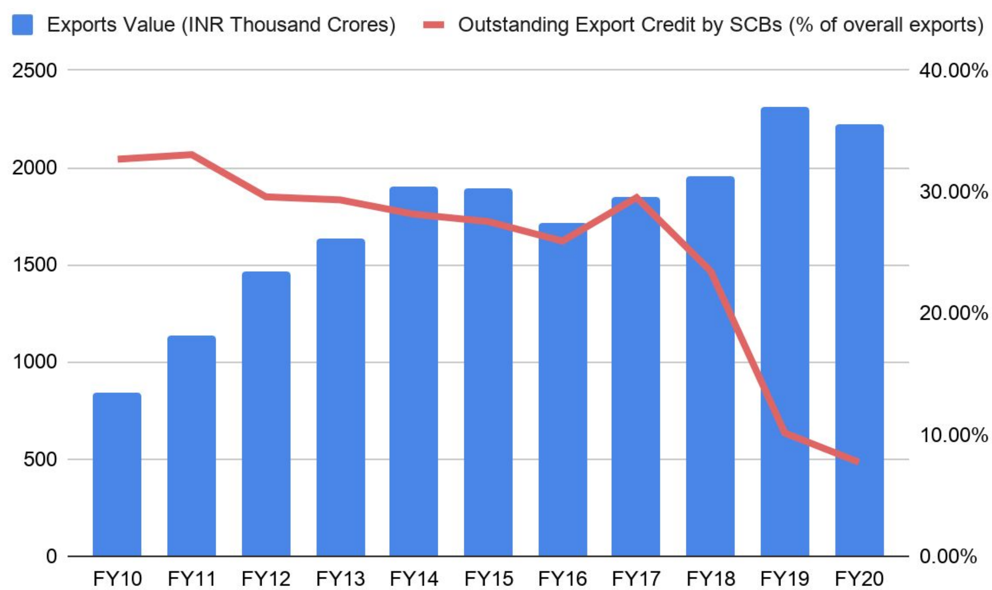

Fig 4: Indian Exports Value vs Outstanding Export Credit by Banks[5] (as % of overall exports) (Source: Reserve Bank of India)

The proposed Remission of Duties and Taxes on Exported Products (RoDTEP) scheme could also prove to be a good way of balancing the scales. Delays in refunds of GST and other claims have been a common exporter complaint, and efficient remission of duties will help address a

[5] Outstanding Export Credit refers to credit given out by Scheduled Commercial banks under the priority sector as per RBI.

significant portion of the working capital shortfall in the sector. Of course, the government must ensure that the provisions of this new scheme are WTO-compliant, to avoid a repeat of what happened with the MEIS.

The COVID-19 pandemic has also offered India an opportunity to take a look at its economy and ecosystem and revisit problem areas, such as supply chain and logistics. The government's new Atma Nirbhar India campaign holds great promise to smoothen the supply chain for manufacturers and exporters. Beyond building domestic manufacturing capabilities, spending money on logistics, warehousing, port upgradation, enhanced turn-around-times of ships, single-window clearances of all export-related paperwork, etc. could provide a significant boost to India's supply chain and resultant exports.

As part of building self-reliance in Indian exports, two more areas need particular focus -- tech upgradation and upskilling. The Technology Upgradation Fund Scheme (TUFS) played a significant role in modernizing the Indian textile industry and making it a global force to be reckoned with. The success of TUFS can be replicated across many other cottage and MSME industries such as plastics, food processing, etc. Providing incentives and support for tech upgradation could have a ripple positive effect on Indian exports and the wider economy for years to come. Upskilling is also another area the government needs to focus on. The Pradhan Mantri Kaushal Vikas Yojana (PMKVY) offers a great platform for this purpose. By linking its skill training provisions to export-oriented industries, the government could provide a significant boost of highly skilled labor to India's export sectors, enabling the creation of more globally competitive products.

Lastly, the role of export promotion councils (EPCs) can be revisited to help market Indian goods better. These EPCs already enable matchmaking between buyers and sellers and help provide necessary information to sellers about markets to target. Their networks can also be utilized to explore ways to find new markets for innovative Indian products and actively promote them to overseas buyers. Before they can grab a piece of the global market, Indian goods and their quality need to be known and recognized by buyers, and EPCs are the perfect mechanism to make this happen.

In many ways, the COVID-19 pandemic has created opportunity as much as adversity. By pausing most economic activity around the world, the pandemic has offered countries the chance to hit a virtual reset on problem sectors, and find new ways to tackle systemic issues. The same is true for Indian exports, which now stand on the brink of a new world of possibilities. With the right forward-looking measures and support from all relevant stakeholders, the Indian export ecosystem will have a huge role to play in realizing the dream of making India a $10 trillion economy by the end of the coming decade.

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