The External Sector and Economic Growth - Indian Experience

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This paper examines the trend in the behavior of the external sector of Indian Economy and its impact on economic growth since 1950-51. The dynamics of the external sector is captured in terms of the behavior of some indices like the index of trade integration; financial integration; net external position (NEXT); equity integration and also by studying the behavior of the current account balances , the capital account balances and the position of the net foreign asset (NFA) as well as international reserves since independence. For capturing the long run dynamics of causality between economic growth and the various indices we have made time series econometric analysis. It is found that the net external position of Indian Economy has improved substantially over the long period and especially after trade and financial liberalization which in turn has led to bring down the volatility of macro fundamentals or instability of Indian Economy. It is also found that since the period of globalization the discrepancy in NFA, the financial and equity integration of our economy have increased significantly but this has in no way affected the steady growth process and stability of our economy. The econometric analysis (ADF and PP tests for stationarity of series) reveals that all the indices as well as the variables including the GDP growth are non-stationary at their levels but are stationary at their first differences. The co-integration analysis clearly establishes the long-run equilibrium relations i.e. causality between the GDP growth and trade integration, financial integration, the NFA, NEXT .The vector error correction estimates also confirm the correction of short-run disturbances from long-term trend so that the explained and the explanatory variables move towards the long-run steady state path(i.e. convergent). This happens in the cases of relation between growth and financial integration, trade integration, NEXT and NFA. The similar result is also found from the co-integration analysis for other variables but the vector error correction estimates of the long-run causality between the domestic inflation and the financial openness reveals that the short run disturbances are not corrected and are divergent. However in case of the relation between the inflation rate and the GDP growth although the co-integration analysis establishes a long-run causality, the vector error correction estimates reveal the divergence from long-run path due to short term disturbances which seems to be due to the domestic supply side constraint. Further we find that the trade integration, the financial integration, the NFA and the net external position have no significant positive long run contribution towards the growth of our economy. However they have significant positive contribution to GDP growth in the short run especially during the post full fledged liberalization period. Further we find that the external sector liberalization has helped bringing down the volatility as well as the instability of our economy.

Key words: Economic Growth; Trade Integration; Financial Integration; Equity integration; Net External Position; Cointegration; Vector Error Correction

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