# Chapter 1

## Introduction

The relationship between trade and economic growth has been one of the most widely investigated in developing literature. Even though international trade cannot in general be expected to be an engine of growth today, there are still many ways (besides the static gains from comparative advantage) in which can contribute to the economic growth of today's developing nations. Moreover, development in endogenous growth theory starting with Romer (1986) and Lucas (1988) provide a more convincing and precise theoretical basis for the positive relationship between international trade and long-run economic growth. Specifically, the new theory of endogenous economic growth postulates that lowering trade barriers will speed up the rate of economic growth in the long run by allowing developing nations to absorb the technology developed in advanced nations at a faster rate than with a lower degree of openness. Secondly, increasing the benefits that flow from research and development (R&D) and encouraging greater specialization and more efficiency in the production of intermediate inputs or leading to the more rapid introduction of new products and services (Salvatore).Hence, the overall growth of countries can be generated not only by increasing the amounts of labour and capital within the economy as the classical economists postulates, but also by expanding exports to wider markets. According to the Exports –Led Growth hypothesis, exports can perform the function of an 'engine of growth'. The association between exports and economic growth is often attributed to the positive externalities for the domestic economy arising from participation in world markets, for instance, from the re-allocation of existing resources, economies of scale and various labour-specialization effects (Bhagwati, 1978; Krueger, 1978). Moreover, export can cause more import of intermediate goods which leads to increase of capital accumulation and output growth.

Most of the countries liberalized their economy, reformed their institutions and improved infrastructure facilities to attract more capital inflows. However, India, the late comer in this process, has initiated its economic reforms in 1991 only and opened the door widely for the multinational companies. The opening up of International Trade should be seen as a crucial aspect of the new approach to economic Policy. The liberalization of the Indian economy had a

favorable impact on India's trade. According to the RBI Annual data source, total export was just Rs. 15.4 billion in the year 1970-1971and it was increased up to Rs. 1063.5 billion in 1995-1996and it further rose to aroundRs 14592.8 billion in the period of 2011-12.Moreover, India's share in global exports and imports also increased from 0.7 per cent and 0.8 per cent respectively in 2000 to 1.6 per cent and 2.5 per cent in 2011.Resently, India's ranking in the leading exporters and importers also improved which was 31 and 26 in 2000 to 19 and 12 respectively in 2011(Economic survey, 2012-13). So we can see a positive and effective shift took place after trade liberalization period with special emphasis on export-led growth policy.

However, several studies were carried out to check the role of exports on economic growth. But besides this, the present study explores relationship between export instability on economic growth. Whether export instability depresses economic growth or encourages economic growth in the short run as well as in the long run. In the relevant literature, export instability has been perceived or defined as an average of the unexpected and unpredictable changes in exports revenues over a period of time. Usually, several studies highlighted that the main causes of export earning instability is elastic demand and supply function. Instability in exports arise both side, either fluctuations in demand or fluctuations in supply side.Some literature proved that the demand fluctuations are the dominant cause of instability while other proved that the supply fluctuations are the dominant cause of instability of exports in different time period.Several studies defined that most of Developing countries export primary products and many households in developed nations spend only a small proportion of their income on such commodities such as tea, cocoa and sugar. Consequently, when the prices of these commodities change, households do not significantly change their purchases of these commodities resulting fluctuations arises in demand side. At the same time, the demand for exports of developing countries is unstable because of business cycle fluctuations in developed nations. On the other hand exports became elastic if trading countries face a situation of Expansion in their business cycle. Expansion in business cycle situation increases economic of scale, investment, infrastructure facilities which raises output and exports more towards developed countries. Recently, to discover the relationship between Exports instability and economic growth is important because of its effects on internal economic stability, on rate of economic growth and on the distribution of income. It is also considered important because of its effects on internal and external policies of many countries (Coppock, 1962).Further;exports earnings affect consumption expenditure, investment

and bank deposits. Thus, the effect of these is transmitted to the rest of the economy by the multiplier accelerator process. Though, several studies were carried out to check the impact of export instability on economic growth has deferred two fairly distinct views.

The first view emphasizes the negative impact of export instability on growth. Specially, Adam and Behrman (1982), Krueger and Wilson (1983) discovered the adverse effects of exports instability on economic growth in their literature. This view based on the argument that volatility in exports earnings increases uncertainty, it has detrimental impact on private investment decisions and adversely effects on capital accumulation. In such economies, risk adverse private investors are likely to reduce their investment. Moreover, this economist argumentthat decreased export earnings imply inability to import inputs or inability to import them at the time when needed during the production process. Further, exports instability of any countries may create economic instability of the domestic country as well as other countries of the world because this world has been synchronized by the process of globalization, so it needed to give much attention to the effect of export instability on economic growth.

On the other hand the second view argues that exports instability does not depress economic growth rather instability has a positive effect on economic growth. The second view based on Friedman's permanent income hypothesis whereby a transitory rise in income due to deviations of export revenues from their trend will leave consumption unchanged and savings will rise which is believed to raise the level of investment and the rate of economic growth (K.K Kaushik, 2008). To fulfill their objectives these economists utilized various methods to measure exports instability index.

Early empirical studies focused on the impact of export instability in economic growth. But more recently, attention has shifted to the direction of causal relationship between export instability and economic growth. The present study is an attempt to identifythe impact of exports instability on economic growth in case of Indiaby using time series econometric techniques such as co-integration and error-correction models. The main focus of the study is to know, whether export instability depresses economic growth or encourages economic growth in the short run as well as in the long run.

## 1.1 Statement of the Problem

Despite a large amount of previous literature on the subject, the role of exports instability on economic growth remains controversial. In relevant literature regarding exports instability and economic growth two school of thoughts have been emerged. The first view emphasized the negative impact of exports instability on economic growth (see Rashid and Ullah, Ramli, Tehseen, Bakar, Gholamrezaetc).On the other hand second view emphasizes that the positive impact of exports instability on economic growth (see K.K Kaushik,Ghosh and Ostry, Mcbean, Knudsen andparnesetc).

In such a situation, it needs to investigate the relationship between exports instability and economic growth in India because exports contribute a large share in India's Gross domestic production. Moreover, exports volatility hasdirect effects on individual's earnings because this is a part of gross domestic production and volatility in exports earnings creates change in the investment pattern, saving behavior and consumption expenditure. Therefore in present scenario, it is important to examine whether exports instability depress economic growth or it may encourage economic growth in short run and long run. Based on the above considerations, this study framed these objectives.

## 1.2 Objectives of the Study

- To carryout unit root tests to know whether the macroeconomic variables are stationary or not.
- To carryout cointegration tests to know whether the macroeconomic variables are cointegrating and what is the number of cointegrating vectors.
- To examine the impact of exports instability on economic growth in India both long run and short run.

## 1.3 Limitations of the Study

The present study based on yearly data. Apart from EXP, GFCF, and DV, there can be numbers of variables such as real imports, import instability and term of trade index drive the economic

growth of a country. But the present study has employed variables such as GDP, Gross fixed capital formation, real exports earnings, and dummy. Further, the study also used dummy variable. Gross fixedcapital formation and real exports earnings are modeled in natural logarithms. Exports instability index modeled in absolute term. In this study our primary focus is to examine the impact of exports instability and economic growth in case of India both long run and short run.

**1.4 Organization of the Study**

The contents of the present study on "Exports instability and economic growth in India "have been organized into six chapters:

Chapter: 1 Thischapter presents a brief introduction focusing on statement of the problem, objectives of the study, and limitations of the study.

Chapter: 2 Thischapter presents a brief review of literature relating to the theme of the present study.

Chapter: 3 This chapter deals with a brief profile of India's export focusing on foreign trade policy over a different period of time, Growth and structure of India's exports, Index numbers of foreign trade, Composition of foreign trade, Share in world merchandise exports of selected countries.

Chapter: 4 This chapter present the data description and methodology. This section describes the selection of the variables, brief description of data and econometric tools such as unit root tests, Johansen co-integration tests, and Error correction model to investigate the impact of exports instability and economic growth.

Chapter: 5 This chapter deals with the empirical analysis presents the results and their interpretation.

Chapter: 6 This chapter contains the conclusion of the present study. Finally, the study presents relevant appendix andtheBibliography of the dissertation respectively.