

# Contemporary Issues in International Trade

## Challenges and Opportunities

Rajib Bhattacharyya  
Debashis Mazumdar



# **Contemporary Issues in International Trade**

This edited book is a collection of papers presented in an international conference and pre-conference workshop organized by the Heritage College, Kolkata in collaboration with Goenka College of Commerce and Business Administration, Kolkata, India. The admirable range of topics and geographic location of speakers can easily signal the wide impact this volume is likely to have on research and pedagogy. The usual professional appetite of the field of international trade restricts itself to the analyses of welfare and efficiency aspects of trade theory and policy with reference to standard institutional framework such as the WTO and respective governments. This volume goes much beyond such usual terrain of engagement and brings to the fore critical issues which confront us and demand urgent analytical attention. Some examples, as included in the volume, are Trade and Human Capital Formation, Role of Block Chain Technology and Fake News in the context of trade strategies, the implications of BREXIT and Russia-Ukraine war for the developing world, impact of trade on marginalized communities, etc. Such topics do not overshadow more mainstream issues and authors provide fresh perspectives about them also. The holistic get together of scholars and topics under the same umbrella of this volume is indeed a rare treat. This volume would not only help researchers working on the frontier of trade policy and variety of trade shocks, but it would be a very useful toolkit of ideas for students and teachers of international trade, all across the globe. The editor deserves to be congratulated for a job done well.

*Professor (Dr) Sugata Marjit*  
**First Distinguished Professor, Indian Institute of Foreign Trade**  
**Former Vice-Chancellor, Calcutta University**

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- v. Dr Anisha Sen, *Assistant Professor and HOD, Department of English, The Heritage College, Kolkata.*

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# Contemporary Issues in International Trade: Challenges and Opportunities

EDITED BY

**RAJIB BHATTACHARYYA**

*Goenka College of Commerce and Business Administration, India*

AND

**DEBASHIS MAZUMDAR**

*The Heritage College, India*



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INVESTOR IN PEOPLE

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## About the Editors



**Dr Rajib Bhattacharyya** is an Associate Professor (WBES-A) in the Department of Economics, Goenka College of Commerce and Business Administration, Kolkata, India. He obtained his bachelor degree in Economics from St Xavier's College, Kolkata, and his master degree in Economics, from University of Calcutta. He did his MPhil and PhD in Economics, both from the University of Calcutta. He has 22 years of teaching experience at the undergraduate and postgraduate levels. His fields of interests are international trade, finance, Indian economic development, and women empowerment. He has contributed a good number of articles in reputed national and international journals/books, viz., IGI Global (USA), Emerald (UK), Taylor & Francis, and Springer. He has been invited to deliver lectures in many UGC sponsored Seminars/Webinars/Conferences. He has also worked as a member of the editorial board of various national and international level journals. He had been conferred the best paper award in an International Seminar on "Recent Trends and Perspectives in Economics" on January 2016. He has served as an invited reviewer in Indian Economic Journal (Sage), Foreign Trade Review (Sage), Journal of Asian and African Studies (Sage), and International Journal of ICT Research and Development in Africa (IGI Global). He also has the experience of guiding PhD students.



**Dr Debashis Mazumdar** is now serving at The Heritage College, Kolkata, West Bengal, India, as a Professor and HOD in the Department of Economics. He has been teaching Economics both at undergraduate and postgraduate levels for the last 42 years. He completed his postgraduate study in Economics from Jadavpur University, Kolkata; M Phil in Economics from the University of Calcutta; and done his PhD from Rabindra Bharati University, Kolkata. He started his career as an Assistant Professor in Economics in a Government College of South Tripura. During his service period he has served at Sudhiranjan Lahiri mahavidyalaya, Nadia, and Bangabasi College, Kolkata. He has also been working as a Visiting Faculty at the PG (Commerce) section of Nababullygunj Mahavidyalaya, Kolkata, since 2013. He was also an empaneled research guide for PhD scholars at Vidyasagar University, Madinipur, West Bengal, and two scholars have been awarded PhD degree under his guidance. He has authored/co-authored about 40 text books in Economics (some of which are the prescribed text books at the undergraduate level of Calcutta University), contributed about 65 research articles in national and international journals and edited two conference volumes. He has also worked as a Reviewer of Book Proposals and as a member of the Editorial Board in reputed publishing houses like IGI Global (USA), Emerald (UK), Routledge, etc. His research areas consist of international trade, green marketing, rural development, etc.

## About the Contributors

**Aaheli Ahmed** is currently a Doctoral Scholar at IIFT. She has previously taught at the graduate level in the Department of Economics, Jogomaya Devi College (under University of Calcutta). She has also undertaken research projects funded by the Ministry of Commerce and published her research both in India and abroad.

**Salma Akhter** is now holding the post of Professor of Sociology, Dhaka University, Bangladesh. She completed her MPhil in Sociology from the University of Cambridge, UK, in 1997. She received a fellowship for gender research at Helsinki University, Finland, in 2000. She has a long experience in consultancy and research in the fields of sociology, anthropology, and gender studies. During her teaching career, she has undertaken several projects sponsored by UNDP, World Bank, ADB, UNESCO, Save the Children, Plan International, UNWFP, UNV, Danida, Royal Norwegian Embassy, Danish Embassy, ILO, IFPRI, Tradicraft, Oxfam, UNICED, UNCDF, JICA, ITDG, and Government departments during 1991–2019. Her research works have been published in several reputed journals.

**Nishat Alam** is currently pursuing a postgraduate program in Economics at University of Calcutta. She specializes in the area of development economics, econometrics, and international trade.

**Subhasree Banerjee**, PhD Student, Indian Institute of Foreign Trade, Kolkata Campus. Subhasree has a Masters in Economics from Delhi School of Economics and has worked for over two decades in the financial sector, in organizations like ICRA, HSBC, Standard Chartered Bank, Moody's Analytics, and Fitch Ratings. At present, she is pursuing PhD in Economics at IIFT. Her research interest includes technology intensity of Indian manufacturing and exports.

**Ripudaman Bhardwaj** is a Research Associate at Reserve Bank of India (RBI), Mumbai. He is a Research Associate at Centre for Advanced Financial Research and Learning (CAFRAL), Mumbai.

**Ranajoy Bhattacharyya** is currently the Professor of Economics at Indian Institute of Foreign Trade (IIFT), Kolkata. Before joining at IIFT Kolkata, he served as a Visiting Professor, Roanoke College, Salem, Virginia, US, in 2007; as Reader, Department of Business management, Calcutta University during 2007–2008; as Visiting Fellow, Sejong University, Seoul, Korea, during 2003–2007; as a Senior Lecturer, Department of Business Management, Calcutta University during

2002–2003; as a Visiting Lecturer, Department of Economics, Calcutta University during 1997–2003; as a Visiting Lecturer, XLRI, Jamshedpur, since 1992; and as a Lecturer, West Bengal Educational Service, during 1991–1995. He was the recipient of the Fulbright Scholar in Residence award in 2007–2008 and the Asia Fellows award in 2002–2003. His area of interest lies in international economics and environmental economics.

**Mainak Bhattacharjee** is currently an Assistant Professor in Economics at Loreto College, Kolkata, India. He has also worked in the same post in The Heritage College, Kolkata, India. He has obtained MPhil and MA in Economics, respectively, from the Jadavpur University. He has been working in the areas of Macroeconomics and International Trade. He has produced many research articles published in reputed journals.

**SK Bhogal** is the Dean, Humanities & Social Science, Shri Venkateshwara University, UP, India.

**Atreyee Sinha Chakraborty** is an Associate Professor at Gokhale Institute of Politics and Economics (GIPE), Pune, India. Atreyee's primary research interests are international trade, with a special focus on non-tariff barriers. Her secondary focus area is the economics of discrimination, the reasons behind the persistence of gaps in attainments for marginalized groups. She has published more than 12 research papers in peer-reviewed journals with high impact factors. She has also presented more than 15 research papers in different national and international conferences.

**Debashis Chakraborty** is a Professor at Department of Economics, IIFT, Kolkata. His research interest includes international trade, environmental sustainability and economic development. For the last decade, he is the Editorial Board member of *Foreign Trade Review* (Sage), a comprehensive forum for disseminating theoretical and empirical research on international trade-related issues.

**Saumya Chakrabarti** is a Professor of Economics, Visva-Bharati, Santiniketan. He taught at St Xavier's College, University of Calcutta, and Presidency University. Professor Chakrabarti was a visiting fellow at Brown University. He was an Honorary Director, Agro-Economic Research Centre, Santiniketan. He has published for the Cambridge Journal of Economics, Review of Radical Political Economics, Economic and Political Weekly, Oxford University Press, etc. He has contributed considerably to vernacular dailies.

**Nilendu Chatterjee** is an Assistant Professor in the Department of Economics, Bankim Sardar College (affiliated to University of Calcutta), West Bengal, India. He has research interests in resource economics, international economics, econometrics, and development economics. He has published a number of research articles in several international journals of economics including International Journal of Sustainable Economies Management, Economic Affairs, Foreign Trade Review and Journal of Knowledge Economy, Springer, Routledge, and many more. ORCID - <https://orcid.org/0000-0002-8570-0262>.

**Riddhi Chatterjee** is an Assistant Professor at Department of Economics, Sree Chaitanya College, Habra. Her research area and specialization includes international economics and environment and resource economics.

**Tonmoy Chatterjee** is an Assistant Professor in the Department of Economics, Ananda Chandra College, West Bengal, India. He has research interest in international trade theory, general equilibrium, health economics, and development economics. He has published a number of research articles in several international journals of economics including Review of Economics, International Journal of Sustainable Economics Management, Economic Affairs, Foreign Trade Review, and The Pakistan Development Review. ORCID- <https://orcid.org/0000-0001-9666-479X>.

**Bibek Ray Chaudhuri** is a Professor at Indian Institute of Foreign Trade, Kolkata Campus. He did his PhD in Economics from Jawaharlal Nehru University, New Delhi, India. He is currently the Professor of Economics at Indian Institute of Foreign Trade (IIFT), Kolkata, India. He started his career as a Consultant at the National Council for Applied Economic Research (NCAER), a leading think tank in New Delhi, India. He was a Visiting Fellow at School of Environment, Education and Development (SEED), the University of Manchester, UK. His research interests include trade, microfinance, and political marketing. He has published in journals like Journal of Business Research (Elsevier), Market Intelligence and Planning (Emerald), Journal of Political Marketing (Taylor and Francis), Journal of Industrial Statistics, Journal of Asian Business Studies (Emerald). He was a recipient of the prestigious “Japanese Award for Outstanding Research on Development”, conferred by Ministry of Finance, Government of Japan and Global Development Network (GDN). An avid traveler and likes to visit places; other hobbies include reading and sports.

**Pratip Kumar Datta** is an educator specialising in Economics and Mathematics at Rajatpur I.N. Vidyapith, Bolpur, India. He’s a member of the Economics Research Committee, XLVI Indian Social Science Congress 2023. Datta’s research contributions are published in journals and books from the Review of Radical Political Economics, Routledge, IGI Global, etc., and he actively participates in sociopolitical discussions through newspapers, news portals, and popular journals.

**Dr Oindrila Dey** is an Assistant Professor of Economics and the Program Director for the Master of Arts in Economics. She is also a fellow of the Global Labour Organization. Her areas of interest for research are Applied Microeconomic Theory, Trade, and Development Economics.

**Ajanta Ghosh** is a research scholar at St Xavier’s University, Kolkata. She has an MBA and MCom degree from the University of Calcutta. She is working as an Assistant Professor of Finance at Institute of Engineering & Management, Kolkata, for the last 11 years. Prior to that she has a corporate experience of 9 years.

**Sitangshu Khatua** is an Associate Professor Finance St Xavier’s University, Kolkata. He has a PhD (XLRI), MBA, BTech (NIT), MTech (CU), CFA, and ERP. He had presented several research articles in national and international

conferences in India and abroad and published 50 papers in peer-reviewed well-rated journals. He has authored six books, like *Financial Economics* and *Project Management & Appraisal from OUP*.

**Rishab Lodh** is pursuing his PhD in Economics at Indian Institute of Foreign Trade, Kolkata. He is presently working in the area of Fake News and Asymmetric Information. His research interests lie in game theory, network economics, and applied microeconomics.

**Kalpita Ray** is an Assistant Professor in the Department of Economics, Surendranath Evening College, Kolkata, India. She has research interest in industrial economics and trade policies. She has published a number of research articles in number of reputed journals and edited books.

**Saikat Sinha Roy** teaches Economics at Jadavpur University, Kolkata. Until recently, he was the Coordinator of the Centre for Advanced Studies, Department of Economics, Jadavpur University. He holds a PhD from Jawaharlal Nehru University, New Delhi, done at the Centre for Development Studies, Thiruvananthapuram. His areas of academic interests include open economy macroeconomics, trade and development, and applied trade modeling, among others. Currently, he is part of a global research project titled “Special Economic Zones: A force for good to reduce inequality?” funded by Riksbankens. He has published in various national and international journals, and in edited volumes including a recent co-edited book titled *International Trade and International Finance: Explorations of Contemporary Issues*.

**Siddhartha Roy** is presently an Associate Professor in Computer Science and Engineering (IoT) Department, University of Engineering and Management, Kolkata. He has completed PhD in Computer Engineering from Jadavpur University, India. He did MCA from the Indian Institute of Science and Technology (Previously Shibpur BE College), India, obtained MBA in Operational Management, and graduated in Mathematics Honors from St Xavier’s College, Kolkata, India. He had taken professional development training from TAFE, Adelaide, South Australia. His main research interest includes machine learning, deep learning, blockchain application, and network security. He has several publications both in national and international level peer-reviewed journals and is also the author of several textbooks at undergraduate levels.

**Samrat Roy** is currently the PhD Coordinator and Assistant Professor in Economics in the postgraduate and Research Department of Commerce, St Xavier’s College (Autonomous), Kolkata. His research interests include applied macro econometrics and international economics. Dr Roy has published research papers in national and international journals of repute.

**Sonali Saha**, a Research Scholar, is presently working as an Assistant Professor at St Xavier’s College (Autonomous), Kolkata. She has completed her MPhil from the University of Calcutta and has taught in various colleges of repute. Her research interests are in the area of insurance, banking, and other economic issues.

**Gautam Samaddar** is the Ex-Regional Director of Philips India Limited and CEO of Mission Hospital, Durgapur. He has 32 years of experience in deal closing from both sides of the table (as a customer as well as a supplier for B to B & B to C). He is pursuing PhD in Management at Shree Venkateshwara University, UP, India.

**Subhasis Santra** is an assistant teacher in Economics in Calcutta Airport English High School (H.S), Kolkata, India. He has been awarded PhD degree in Economics by Vidyasagar University, West Bengal, India, in 2022. His area of interest is contemporary issues on India's foreign trade.

**Darpajit Sengupta** is a Senior Research Fellow pursuing his PhD in Department of Economics, Jadavpur University, Kolkata. He is the recipient of UGC-NET fellowship. He had interned with MOSPI, GOI. He was a Visiting Faculty at Scottish Church College (2017–2019) and St Xavier's College (2023). His research interest lies in open economy macro modeling, international trade, and applied econometrics.

**Soumyen Sikdar** is a (Retd.) Professor, Indian Institute of Management, Calcutta, since 2009. He did his BA (Economics) at Presidency College, Calcutta, MA (Economics) at University of Calcutta, and was awarded PhD (Economics) from University of Minnesota, US. He served as Associate Professor, Centre for Economic Studies, Presidency College, Calcutta (January 1986 to December 1990); Professor, Burdwan University (January 1991 to March 1995); Visiting Fellow IGIDR, Mumbai (August–September 1993); Professor, University of Calcutta (April 1995 to March 2009); Visiting Professor, Institute of Social and Economic Research, Osaka University, Japan (September 1998 to February 1999, August–November 2008); Visiting Professor, Shenzhen University, China (November 1–25, 2009). He has contributed in many national and international journals of repute and has also published several valuable books from Oxford, Springer, and others.

**C Veeramani** assumed the position of the 10th Director of the Centre for Development Studies (CDS), Thiruvananthapuram, India on June 1, 2023. Previously, he served as a Professor at the Indira Gandhi Institute of Development Research (IGIDR) in Mumbai, as an Associate Professor from May 2006 to January 2018, and as a Professor of Economics from February 2018 to May 2023. He holds a PhD and MPhil in Economics from Jawaharlal Nehru University (JNU), New Delhi. Before joining IGIDR, he worked with the Indian Council for Research on International Economic Relations (ICRIER) in New Delhi and the Indian Institute of Technology (IIT), Bombay. He was a Visiting Fellow at the Crawford School of Public Policy, Australian National University. He is the recipient of the EXIM Bank International Economic Development Research award 2003 for the best doctoral dissertation in international economics. Professor Veeramani serves as the Joint Managing Editor of the Journal of Quantitative Economics and as the Economics Area Editor of the Journal of Indian Business Research.

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*Editors*

# Introduction

The past two decades have been a turbulent period for the global economy, opening with the global financial crisis and passing through Brexit, election of an American president with an “America First” agenda, COVID-19 pandemic, and the ongoing Russia-Ukraine war. The crisis brought to the forefront multiple challenges as well as opportunities. Given this backdrop, this edited collection of chapters is expected to shed new light on the challenges and opportunities in global trade and correspondingly on strategies to be followed by the policymakers while framing the new Trade Policy.

The world is going to witness the third weakest pace of growth in nearly three decades as global growth is expected to decelerate sharply to 1.7% in 2023, particularly due to recessions caused by the pandemic and the global financial crisis. The United States, the euro area, and China are all undergoing a period of pronounced weakness, and the resulting spillovers are exacerbating other headwinds faced by Emerging Market and Developing economies (EMDEs). The combination of slow growth, tightening financial conditions, and heavy indebtedness is likely to weaken investment and trigger corporate defaults. Further negative shocks – such as higher inflation, even tighter policy, financial stress, deeper weakness in major economies, or rising geopolitical tensions – could push the global economy into recession.

WTO rules underpin the bulk of global merchandise trade. But we need to update the rule book to respond to the 21st century issues: changes arising from digital economy as well as global commons challenges such as climate, health and social inclusion.

Dr Ngozi Okonjo-Iweala, Director General, WTO

The biggest losers from international trade are always those whose skills have a cheaper competitor in a different market.

Dr Gita Gopinath, Deputy Managing Director, IMF

The flow of goods and services through cross-border trade across nations has shown an increasing trend during the last few decades with occasional ups and downs during, say, East Asian Crisis (1997–1998), financial crisis (2008–2009), pandemic period (2020–2021), etc. When measured in terms of trade openness, viz., the sum total of world exports and imports as a proportion of world GDP, a gradual increase

is observed on this front during the same period. However, both country specific data as well as world level data clearly indicate the impact of shocks arising out of the events already noted. It is believed that a liberalized trade environment has definitely contributed toward productivity growth in the import competing sector. With a gradual decline in trade barriers, local markets respond and prices of different goods and services also change. This effect percolates to the non-traded goods also and impacts the welfare of the households of different countries. As trade openness leads to changes in factor prices through the creation of demand for specific type of factors, income shares of factors also change across nations. While trade affects wages and employment, it also affects the prices of consumption goods. So households are affected both as consumers and as wage earners.

The acceleration of economic growth, its stability, and long run sustainability in globalized economic regime depends heavily on its two pillars, viz., trade and finance. So, over the last three decades the benefits and costs of trade liberalization and financial integration are most intensely debated topics which have gathered momentum in recent day world. Sound macroeconomic stability, financial integration and development, acceleration of international trade, and strict control over exchange rates volatility are the potential channels through which integration enhances growth and long run sustenance. The future of the emerging nations of Asia and the fate of the developed advanced countries heavily depends on whether they can reap the benefits of this integrated and globalized world.

There are people (including Stanley Fischer and Lawrence Summers) who believe that increased openness to capital flows has, in general, proved essential for countries seeking to rise from lower to middle-income status and removal of restriction on trade and capital flows may usher huge benefits by easing various constraints. But on the contrary, there are others (for example, Dani Rodrik, Jagdish Bhagwati, and Joseph Stiglitz) who argue that deregulation of financial markets would have devastating effect on emerging market economies in the long run and unfettered capital flows may disrupt global financial stability, leading to calls for capital controls and curbs on international asset trade. Empirically, emerging market economies have clearly registered better growth outcomes, on average, than those countries that have not participated in trade liberalization and financial globalization. Yet there are many cross-country studies which failed to establish a positive link between capital account liberalization and growth. The development of BRICS and Britain's exit from the European Union (EU) has also raised several questions to the future of trade openness and financial globalization.

This book attempts to incorporate a wide range of contemporary issues in international trade and finance that have assumed significance in the aftermath of the COVID-19 pandemic. A brief summary of the chapters is given below.

*Chapter 1* focuses on the global recessions and their characteristics at different time periods. It raised the issue whether the present global scenario points out toward a slump and whether global recession is imminent. The study points out toward some major flaws in the system which are being overlooked in most cases, e.g., problem of rising global inequality in income and wealth. It raised the

question whether even stable growth in GDP per capita is desirable in a highly inequitable society. It also highlights how policy rate changes are supposed to control inflation by changing aggregate spending in the system. It further criticizes incorrect monetary policy and faulty regulation of private banks and other financial institutions.

*Chapter 2* demonstrates how the reduction of tariff barriers and advancements in transportation and communication technology have facilitated the fragmentation of production processes across different countries. This has led to a significant transformation in the nature and structure of global trade. Rather than focusing on final goods, countries now specialize in specific stages of the production sequence or tasks. The fragmentation of production and the emergence of new trade patterns have far-reaching implications across multiple domains, from the collection and recording of trade data to the formulation of industrial policies, and even to the understanding of income distribution and welfare influenced by global supply chains.

*Chapter 3* attempts to show that trade can be severely impacted by economic crisis whatever might have been the trigger. The impact can be through demand side factors reducing trade and further reducing income and employment in the process. It talks about the three episodes: the oil Crisis of early 1970s, the global financial crisis of 2007–2008, and the COVID-19 Crisis of 2019. Across product groups, both agricultural and manufacturing goods exports were more impacted during the global financial crisis. Whereas for services exports the impact was severe during the COVID-19 pandemic. Across country groups the high-income countries were more impacted during the first two episodes whereas the LDCs were more impacted during the pandemic. Further, a Gravity Model estimation was attempted to empirically measure the effects of crisis.

*Chapter 4* describes the macroeconomic vulnerability of less-developed countries. A country is vulnerable when it is susceptible to shocks. This paper uses data from 34 developing countries to investigate vulnerability trends for them since the 1990s. It finds that the level of economic development is inversely related to macroeconomic vulnerability. The countries that became less primarily vulnerable belong to the upper middle-income and middle-income groups; the reverse is true for most vulnerable countries up to 2014. Income plays a crucial role in deciding vulnerability in the globalization era. Geographical location is a key factor in measuring vulnerability, especially in African countries. But the reverse result took place in the de-globalization era. In this period, the highest vulnerable countries mostly belong to upper middle- and lower middle-income groups.

*Chapter 5* explores India's potential sectoral trade growth with eight partner countries, in the case of RTA-led tariff reforms, through a WITS-SMART simulation exercise. One of the major objectives of India's National Auto Policy (NAP) (2018) is to help the country emerge as a hub for automotive production and R&D. It further aspires to facilitate growth of both domestic sales and exports, not only in finished product segments, but in the auto-components as well. In order to fulfill this long-term objective, two policies had been proposed by NAP (2018). India is presently engaged in RTA negotiations with several developed and developing countries, with potentially beneficial repercussions for

automobile exports. However, the question of accession to UNECE WP.29 1958 agreement has not received similar attention of late, which may restrain the anticipated sectoral export growth.

*Chapter 6* aims to determine the export price pass-through elasticity, specifically for Indian exports. It employs static and dynamic panel data techniques to estimate these elasticities. Notably, the pass-through effect is more significant in the long term compared to the short term. The dynamic panel analysis, considering broader economic factors, identifies trade openness and global demand as statistically significant in explaining export price variations. Additionally, the study reveals that the response of export prices to exchange rate changes depends on the nature of those changes, with depreciation having a lesser impact than appreciation. Furthermore, this chapter emphasizes the importance of analyzing these effects at the product level for a comprehensive understanding of the underlying mechanisms.

*Chapter 7* describes that India's manufacturing exports are heavily tilted toward primary and resource-based products, while its Asian peers have a significant proportion of high- and mid-tech products in their export baskets. It attempts to examine the hurdles faced by technology-intensive exports by India, using gravity panel estimates on its high, mid, and low-tech exports, using data across 130 countries from 2001 and 2019. The study finds that Non-tariff Measures (NTMs) are a stringent hurdle faced by Indian exports, especially in EU. The index for ascertaining India's relative knowledge base shows that while India ranked 6th in 2017, much higher than its Asian peers, its high- and mid-tech exports lagged behind these countries. This puzzle is explained by the fact that scientific research in India has very little industry collaboration and thus is out of sync with market needs.

*Chapter 8* evaluates influence of liberalization on Indian manufacturing sector using the empirical evidence over 1987–2018. The liberalization initiative commenced in India from 1991 onwards, replacing the four-decade long import substitution policy. The primary objective was to enhance the role of foreign and private investment, in line with the newly embraced outward-oriented growth model. Recent studies have found that when firm heterogeneity is present in trade models, reforms will lead to a decrease in the number of firms and a rise in their average size. A dataset of 24 manufacturing industries had been used in this study to examine this phenomenon. We also attempt to analyze the magnitude of trade costs in terms of the impact of reforms on wages and prices.

*Chapter 9* attempts to investigate the impact of trade flows on the labor market with special emphasis on the recent COVID-19 crisis. Increasing trade liberalization and financial integration with rise in FDI flows have an intense impact on the labor market of both the developed as well as the developing world. The restructuring of economic activity has resulted in destruction of jobs in some parts of the economy and start-ups of new firms in the other part, growing import competition with foreign firms displacing local firms, relocation of jobs from high wage to low wage nations. This chapter seeks to analyze the impact of trade flows on the labor market – job creation or job loss, wage inequality, movement toward informal economy, gender inequalities, and other related issues. The data is based on various reports available from the ILO, WDI, and the UNCTAD and WTO

Trade Reports. The empirical analysis also confirms that there is a unidirectional causality from trade to employment generation.

*Chapter 10* is an empirical study on the relative stance of Indian insurance market within the framework of selected international insurance markets. The study is to introduce a model, Benchmark Ratio of Insurance Penetration (BRIP), for insurance growth comparison across the selected countries. This model makes an attempt to compare the relative stance between a country's insurance penetration and the selected countries average insurance penetration at an economic level which is at par with the country's GDP per capita. The study is done by selecting the G7 countries and the BRICS nations. This chapter uses the data of 12 countries for the past years (2001–2019) as the sample to study the objective of insurance comparison.

*Chapter 11* tries to examine the welfare effects of product standards (which fall under Non-Tariff Barriers (NTBs)) on an exporting country when the country by its own choice prefers to follow the null standard for the domestic market, which is not possible due to high set up cost at two different standards. The model has used a theoretical framework to analyze the effects and has derived some important results. If the standard is not linked with a true negative externality, the exporting country, given the assumptions of the model will always prefer to be discriminated by "tariff" and the importing country will prefer to protect its market by "tariff" rather than going for NTB. Using a game theoretic framework, the study shows that the imposition of standards which does not address any real externality can be an optimum response for an importing country leading to a loss in the global welfare compared to a free trade situation.

*Chapter 12* attempts to investigate the Nexus between international trade, economic growth, and environment for the BRICS economies. Using simultaneous equation model and panel data analysis, the study shows how far these three important issues are influenced by one another and related variables. It found that both GDP and trade-related variables have been influential upon one another. But these variables are getting influenced by emission as well as influencing emission are areas of worries which need to be given immense importance in the coming years.

*Chapter 13* aims at evaluating the theoretical development and security issues with regard to blockchain technology in the global supply chain. Blockchain technology has found significant success in all fields, including the banking and finance sector, health, manufacturing, transportation, and many others. Recently, the researchers have contributed significantly toward understanding blockchain technology and its application in the organizational and technology-specific factors that play a crucial role in driving its adoption in the supply chain. Blockchain technology plays a vital role to maintain trust among the stakeholder of the supply chain. The purpose of this paper is to discuss a theoretical framework for blockchain adoption in the supply chain in business.

*Chapter 14* attempts to examine how misinformation can influence decision-making by fueling individual's belief, prejudices, and stereotypes. In the context of international trade, misinformation refers to the spread of false or misleading information and facts mostly with the malicious intent of maligning reputation of products, services, trade policies, or the trade practices of specific countries.

Stereotypes and prejudices fueled by misinformation coupled with economic nationalism and populism casts a dark shadow over the liberal international order. Misinformation, based on populist beliefs, can escalate trade disputes between countries. These disputes can disrupt trade as well as geopolitical relationships. It motivates us to understand and evaluate international trade in terms of network statistics. This chapter provides an in-depth analysis of 191 trading partners involved in bilateral or multilateral trade agreements.

*Chapter 15* focuses on the changing pattern in volume, nature, and trade balance during liberalization of India's foreign trade in Asia. Both export and import have increased manifold during this period with a faster increment in imports over its exports resulting in a huge trade deficit. This study uses a panel data analysis to evaluate the changes in pattern of India's trade, volume of export and import, and balance of trade with other Asian countries in the context of changes in trade policy, tariff rates, exchange rates, FDI, and economic growth during 1988–2017.

*Chapter 16* seeks to analyze the capital structure and profitability of Indian computer firms in post information technology agreement period. In fact, trade liberalization may affect investment through marginal profitability of asset by varying projected sales and costs of imported inputs, i.e., by altering the imported input price. This study examines the viable relationship between dynamic profitability and directives of the ITA. The sample is selected from 51 Indian computer firms (14 hardware firms and 37 software firms) level data ranging from 2000–2001 to 2018–2019 and by application of dynamic panel data the results are analyzed in this research work. This chapter observes that return on asset is negatively significant with the ratio between short-term liability and total liability for both the software and hardware sector of Indian computer industry in post ITA policy timeline.

*Chapter 17* tries to explore the impact of international trade on the women entrepreneurship of Bangladesh based on the case studies on 50 women entrepreneurs in various levels in Bangladesh and 10 Key Informant Interviews of government officials, business associations, academics, researcher, and micro-credit organizations. This is encouraging that due to government's women friendly policies and organizational supports along with better networking through social media in Bangladesh, more and more women of various backgrounds in Bangladesh are coming to business though still concentrated in few traditional areas but they are making space for themselves and creating employment for poorest segment of women and educated young women.

*Chapter 18* intends to examine that globalization of agriculture via the Evergreen revolution (which encompasses large-scale production-collection-cleaning-processing-packaging-transportation-storage-distribution-sale of high-value cereals-fruits-flowers-vegetables-agrofuel-feedstock through technology-intensive global value chains) has opened the door to corporate capital involvement in agriculture. While the mainstream perspectives and international organizations have optimistically viewed this as a catalyst for inclusive growth, this article seeks to unveil the concealed hegemony of capital underlying the ostensibly beneficial façade of the Evergreen revolution. It underscores the concerns regarding the immiseration of asset-poor farmers, petty non-farm entrepreneurs, and laborers

resulting from the globalization of agriculture. Furthermore, it explores the implications for micro and macro food security in this context.

*Chapter 19* attempts to examine on the relationship between trade, skill formation, and human development in terms of a theoretical model. This chapter seeks to develop a General Equilibrium model in line with Jones (1965 and 1971) and Beladi and Marjit (1996) to address how leveraging of foreign trade through technological modernization of exports may work toward skill formation in less-developed economies with technological dualism, informalization, and disguised unemployment. Besides this chapter brings to glare how benefit of such modernization toward skill development stands out to be weighed against a potential worsening of distributive justice in terms of rise in wage gap between skilled and unskilled workers. Moreover, this chapter seeks to overhaul the implication of liberalization of labor market in terms of dilution of minimum wage standard for human development.

*Chapter 20* discusses the strategic partnership between medical technology companies and healthcare service providers toward global competitiveness. This study tried to analyze the impact of the strategic Key Account Management (KAM) partnership between multinational Medical Technology (MedTech) companies and healthcare service providers, from a global perspective. For the study, primary data were collected through Questionnaires Survey, and secondary data through a review of literature. Secondary data reveals that the Indian Healthcare sector is highly competitive from a global perspective which can be observed by No's of Venture Capital (VC) investment in healthcare, massive growth in Medical Tourism, and huge investment by International Pharmaceutical Companies in India.

*Chapter 21* emphasizes on impact of factoring environment, social and governance in credit rating in India on global capital flow. This chapter focuses on the contemporary issues of including ESG in credit rating and what is the probable impact of doing the same. With favorable rating, companies can access international debt market easily. Moreover, a favorable Sovereign rating is beneficial for the overall economy of a country as better rating enables the Government of the country to access the international debt market. Even capital allocation by foreign institutional investors increases which is beneficial for the equity market too.

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Part A

## **Growth Aspect of International Trade**

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## Chapter 1

# “Imminent” Global Recession: Some Reflections

*Soumyen Sikdar*

Indian Institute of Management, India

### Abstract

The global economy has already experienced recession in 1975, 1982, 1991, 2007 (the Great Recession or the Global Financial Meltdown), and 2020 (The Pandemic Recession). When hope of recovery has just started to emerge with real gross domestic product (GDP) growth reaching 5.7% in 2021, dark clouds are gathering ominously on the horizon again. In January 2022, the World Bank’s forecasts (for global growth) were 4.1% for 2022 and 3.3% for 2023. Not only the indicators like industrial activity are shrinking, consumer and investor confidence is at a low point, workers are losing jobs, profit margins and global trade are showing a downward trend, after a period of post-pandemic expansion. But most worrying is the slowing down of the Big Trio of USA-China-Euro Zone that currently accounts for over 50% of real global GDP in Purchasing Power Parity (PPP) terms and contributed 62% to global growth over 2015–2019. Moreover, energy and food prices are showing rising trend, and Ukraine war is showing no sign of ending in the near future. In this context, the present chapter attempts to analyze whether with prices rising and productive activities (including trade) shrinking (described as “stagflation”), is the world headed for another serious slump, and if that happens, what will be its severity? It also tries to point out some limitations of the policy suggestions of the structural projection models used by the World Bank. It also tries to point out the policy suggestions of the models used by the World Bank.

*Keywords:* Global financial meltdown; pandemic recession; global inequality; greener technologies; fiscal consolidation

*JEL Classification:* G01; E32; D63; Q55; H63

## 1.1 Introduction

Taking contraction in real gross domestic product (GDP) per capita for two consecutive quarters as the definition of recession, the global economy has experienced recession in 1975, 1982, 1991, 2007 (the Great Recession or the Global Financial Meltdown), and 2020 (The Pandemic Recession). Just as it seemed that the world has begun to recover from the worst economic catastrophe since the Second War with global real GDP growth reaching 5.7% in 2021, dark clouds are gathering ominously on the horizon again. In January 2022, the World Bank's forecasts (for global growth) were 4.1% for 2022 and 3.3% for 2023; In August, these were lowered to 2.8% and 2.3%, respectively. All the indicators of recession are in evidence. Industrial activity is shrinking, consumer and investor confidence is at a low point, workers are losing jobs, profit margins are down, and global trade, after a period of postpandemic expansion, is showing a downward trend again. What is most worrying is the slowing down of the Big Trio of USA-China-Euro Zone, a Trio that currently accounts for over 50% of real global GDP in PPP terms and contributed 62% to global growth over 2015–2019. Energy and food prices are rising, and that trend is expected to continue, given that the Ukraine war is showing no sign of ending in the near future. Average global consumer price index (CPI) inflation, which was less than 2% in May 2020, exceeded 9% in July 2022, the highest since 1994. After registering an average growth of 6.2% in 2021, global stock prices were down by 22% in the second quarter of 2022.

So, is the world headed for another serious slump, and if that happens, what will be its severity? With prices rising and productive activities (including trade) shrinking, the slowdown can fairly be described as another serious “stagflation.”

Because of its importance, this question has naturally attracted the attention of economists in a big way. A large literature has already emerged, covering different aspects of the problem, including possible steps to avert it or mitigate its evil effects. There is, as is to be expected, divergence of opinion on its imminence, avoidability, and degree of severity. The World Bank has come out with a number of in-depth studies. Out of this set, we shall pick a particular work – *Is a Global Recession Imminent?* (Guenette et al., 2022).

The report, henceforth GKS, gives a fairly comprehensive description of the major previous global downturns and the recent evolution of global activity. Policy responses to previous slowdowns receive careful attention. Then using a cross country structural projection model, three scenarios are developed – baseline, sharp downturn, and global recession. Policy measures covering the sides of both demand and supply are laid out in some detail. These measures, derived from the projection models, are intended to avert a serious recession and bring the world back closer to the prepandemic trend path.

While commending the effort of the authors in coming up with an interesting and timely document, I cannot refrain from pointing out some limitations that are quite serious in my judgment. It should be pointed out that these limitations are not unique to this particular document. They characterize the overwhelming majority of World Bank publications on contemporary macroeconomic issues.

## **1.2 Limitations of the World Bank Approach**

First and foremost is the omission of the critical problem of rising global inequality in income and wealth. Ever since the triumph of the liberalize-privatize-globalize program unleashed by the Washington Consensus, inequality, both inter country and intra country, has been rising at an alarming rate. This is well-documented by numerous publications including [World Inequality Reports \(2021, 2022\)](#) and the World Inequality Database. Two books, [Piketty \(2014\)](#) and [Stiglitz \(2012\)](#), deal with this issue in great detail. The literature is truly vast, and we refrain from giving detailed references. The World Inequality Report 2022 states: the richest 10% owns 76% of wealth and 52% of income, while the corresponding figures for the bottom 50% are 2% and 13%, respectively. Within each country, both developed and developing, the gap between the average income of the richest 10% and poorest 50% is widening at a rate not observed over the preceding centuries. Periodic surveys of per capita consumption expenditure reveal that the situation in India is also very depressing from the distribution angle.

Economic inequality is not a matter of ethics or justice in distribution alone; it has serious allocative implications too. Since the lower income groups generally have a larger propensity to spend compared to the more affluent sections, falling share of income of these groups will act as a drag on the growth of expenditure, adding to the problem of demand deficiency. There is a hypothesis that more saving by the rich stimulates growth via investment, but empirically this has been validated only for a handful of rich countries that have crossed certain threshold levels of GDP. On the supply side too, inequality has damaging consequences. The poor will be increasingly unable to invest adequately in the health and education of their children, and human capital formation will suffer as a result. Widespread inequality is also likely to cause social unrest, and this will diminish trust, which is a very important component of social capital crucially needed for growth. [Stiglitz \(2012\)](#) contains a comprehensive discussion of the serious adverse consequences of today’s rising inequality for the world’s future.

Actually, revulsion against rising inequity is one of the major drivers of the current disillusion with globalization and the resulting fragmentation of the economic world. Taking everything into consideration, experts (outside the World Bank!) argue that urgent measures are needed to arrest and reverse the current trend of ever-rising inequality in wealth and income. Without such reversal, it would be futile to talk of a future world growing at a sustainable rate, ensuring a decent and rising standard of living for the average citizen.

GKS is genuinely concerned about long-run growth prospects of the world and talks of both demand and supply side measures to achieve growth with stability in the long run but totally ignores the distributional issue. Is growth, even stable growth in GDP per capita, desirable in a highly iniquitous society? On the inequality front, an unacceptable situation has been made worse by the pandemic, but the World Bank stubbornly continues to turn a blind eye to it.

The need for transition to greener technologies with low carbon emission and for reducing the energy intensity of consumption is duly stressed by the Report,

but nowhere is it mentioned that the world's richest 10% currently accounts for 48% of total annual carbon emissions ([World Inequality Database, 2022](#)).

Next, I draw attention to two prevailing obsessions of mainstream thinking, fully endorsed by GKS. The first is the exclusive focus on inflation control as the sole objective of central bank's policy. Under the new dispensation, fiscal action has been relegated to the background. Fiscal consolidation is the mantra of the day because fiscal indiscipline is held to be the path to disruptive debt crisis. And monetary policy is basically left with only one instrument – manipulation of the policy rate by the central bank. Since one instrument cannot be expected to achieve two targets, the objective of maintaining high and stable employment has been quietly thrown overboard. The presumption is that if price stability is ensured, a free-market economy will automatically converge to the state of full employment, where unemployment is at its irreducible natural rate. Mainstream economics clings tenaciously to this belief in the face of strong evidence that price stability alone is no guarantee for stable growth. Even otherwise “healthy” economies with the right fundamentals (including low inflation) may be violently thrown off their trend path by crises originating in and spreading from poorly regulated financial systems.

Policy rate changes are supposed to control inflation by changing aggregate spending in the system. However, evidence reveals that for most economies, consumption and investment expenditures do not show strong sensitivity to interest rate changes. But they do contract if the rate hike is sharp and expected to persist. Number of synchronized policy rate hikes globally started to rise in the second half of 2021, and the process continues to this day. The resulting demand contraction may have put a break on spiraling prices. Our critique of the policy is that raising the cost of borrowing is not the first best action if inflation is actually driven by cost-push factors. The main driver of current inflation is the steep northward movement of oil, energy, and food prices caused primarily by the Ukraine War and the resulting sanctions against Russia. So, supply side measures should take priority over frequent policy rate manipulations.

Actually, rate hikes may well be counterproductive because of their cost push implications. Working capital of firms (wage payments and cost of holding inventories), which is mostly financed by loans, becomes costlier. In another context, sharp increase in borrowing costs has very adverse impact on many emerging market economies (EMEs) that have accumulated debt at a fast pace over the last decade. Sovereign debt was built up mostly to support exceptionally high government spending undertaken to neutralize the devastating impact of the pandemic. Falling asset prices have already put many economic agents under considerable financial stress by reducing the values of collaterals. This will be exacerbated by rising interest rates.

Frequent rate hikes in the United States have made the US dollar very strong since mid-2021. Capital outflows are hurting many EMEs by reducing their ability to finance imports. Weakened currencies are pushing up the cost of imports but are unable to boost exports significantly because of the slowdown in the Trio and the world in general. In June 2023 alone, China's exports have fallen by more than 12%. All these factors generate serious doubts about the wisdom of heavy

reliance on policy rate hikes to address the multifaceted problem of global recession.

GKS stresses “the need to rebuild forex reserve buffer and realign prudential policy to prepare for potential financial stress. Bank capital and liquidity buffers should be sufficiently sound.” This is correct but rather unhelpful in its generality.

Next, we make a few observations on the potential debt creating danger of fiscal action. The new policy consensus is that budget deficits are to be avoided at all costs, chiefly because deficits lead to unsustainable debt servicing cost on future generations. Here the actual nature of current government expenditure is crucial. If it is on spending that helps boost the capital stock of the economy, physical or human, then the benefits will be shared by future generations, and it is not unfair that they should pay for it in the form of higher taxes. The much touted “crowding out” argument against higher government spending is also untenable when such spending is socially productive. Better infrastructure, created and supported by the government, can actually “crowd in” more private investment despite an increase in interest rates. So, the stress in “fiscal consolidation” should be on capping the growth of unproductive public expenditure, not a blanket ban on all budget deficit irrespective of its source. Subsidies for protecting the standard of living of the poor are “productive” because they counter the force of rising inequality.

The vast majority of financial crises over the past half century have had their origin in incorrect monetary policy and faulty regulation of private banks and other financial institutions. The incidence of debt crisis driven by sovereign fiscal indiscipline is much lower in comparison. Perhaps the most desirable way of lowering the need for debt financing (and improving equity in distribution in the process) would be progressive taxation of income and wealth. [Piketty \(2014\)](#), among many others, is a strong advocate of this measure. But most governments, in developing and developed countries alike, are unwilling and unable to do this. And the World Bank never puts pressure on them to do so.

### **1.3 How Serious Is the Threat of Recession for India**

Finally, the question that is most pertinent for us. How serious is the threat posed to India by the “imminent” global recession? Our view is that the impact will certainly be adverse but not likely to create a major recession. The main reason for this optimism is that, thanks to our good diplomatic relations with Russia and Iran, we are less vulnerable to global energy price shocks than most other countries. Besides, due to efficient management of the financial sector and of external debt and the comparatively low dependence on foreign trade, India has always been able to come out of global recessions, including the devastating Global Financial Crisis, relatively unscathed. This robustness and resilience, it is hoped, will continue to stand us in good stead in the present situation too. But inequality of income and wealth is rising alarmingly in our country too ([Oxfam India, 2018](#)) and the Government of India is advised to treat this evil with the utmost urgency.

## 1.4 Conclusion

The foregoing discussion study clearly points out that the global economy is heading toward another severe stagflation in the future. It tries to highlight the trends in the major indicators of global recession. Historical analysis of global recessions reveals that the vast majority of financial crises over the past half century have had their origin in incorrect monetary policy and faulty regulation of private banks and other financial institutions. The incidence of debt crisis driven by sovereign fiscal indiscipline is much lower in comparison. Perhaps the most desirable way of lowering the need for debt financing (and improving equity in distribution in the process) would be progressive taxation of income and wealth. Policy responses must also take account of the critical problem of rising global inequality in income and wealth as widespread inequality, among others, is likely to cause social unrest, and this will diminish trust, which is a very important component of social capital crucially needed for growth. There is also the need for transition to greener technologies with low carbon emission. Exclusive focus on inflation control should not be the sole objective of central bank's policy as "healthy" economies with the right fundamentals (including low inflation), may be violently thrown off their trend path by crises originating in and spreading from poorly regulated financial systems. Besides, due to efficient management of the financial sector and of external debt and the comparatively low dependence on foreign trade, India has always been able to come out of global recessions, including the devastating Global Financial Crisis, relatively unscathed.

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