III. THE EXTERNAL SECTOR

India's balance of payments (BoP), which had deteriorated sharply in 2011-12, showed some improvement in Q1 of 2012-13. The merchandise trade deficit in H1 of 2012-13 has remained at the same level compared to H1 of 2011-12, as fall in exports due to sluggish global demand was almost equally matched by import contraction mainly reflecting slowdown in domestic economic activity. This, coupled with the trend of falling surplus in services trade over the medium term, is likely to leave the current account deficit (CAD) too wide for comfort. CAD financing pressures can re-emerge in the face of event risks, although the recent policy measures announced by the government have helped boost portfolio inflows for now. The rupee strengthened on the back of these flows. Though external vulnerability indicators generally deteriorated in Q1 of 2012-13, India's net international investment position (NIIP) improved, largely due to valuation effects.

Global growth uncertainties continue to impinge on export growth

III.1 India's export growth, which had lost momentum in the second half of 2011-12, mainly owing to a slowdown in external demand, has shown further deterioration in 2012-13 so far (Table III.1). Exports contracted by 6.8 per cent in H1 of 2012-13, with the pace of decline turning more pronounced in Q2. This also shows that the expected positive effects of exchange rate depreciation on exports were muted by weak global demand in the more uncertain macroeconomic environment. Destination-wise data available up to August 2012 suggest that this uncertainty was particularly reflected in the considerable decline in exports to the euro area. Recently, growth in exports to China has also turned negative. Demand from other important export destinations, *viz*., the US and the OPEC countries however, remained somewhat intact. Export demand from most other regional and

Table III.1: India's Merchandise Trade

(US$ billion)

Item		April–March				April-September		
		2010-11 (R)		2011-12 (P)		2011-12 (R)		2012-13 (P)
		Value	Growth (%)	Value	Growth (%)	Value	Growth (%)	Value	Growth (%)
1		2	3	4	5	6	7	8	9
Exports		**251.1**	**40.5**	**304.6**	**21.3**	**154.1**	**40.4**	**143.7**	**-6.8**
Of which:	Oil	41.5	47.1	55.6	34.0	29.2	65.2	25.6	-12.3
	Non-oil	209.7	39.3	249.0	18.8	125.0	35.7	118.1	-5.5
	Gold	6.1	41.9	7.0	14.8	3.6	42.3	3.1	-13.8
	Non-Oil Non-Gold	203.5	39.1	242.0	18.9	121.4	35.5	115.0	-5.3
Imports		**369.8**	**28.2**	**489.4**	**32.4**	**243.5**	**38.1**	**232.9**	**-4.4**
Of which :	Oil	106.0	21.6	154.9	46.2	75.7	51.8	80.8	6.8
	Non-oil	263.8	31.1	334.5	26.8	167.9	32.7	152.1	-9.4
	Gold	40.5	41.6	56.2	38.8	28.4	62.7	19.1	-32.9
	Non-Oil Non-Gold	223.3	29.3	278.3	24.6	139.5	27.9	133.1	-4.6
Trade Deficit		**-118.6**		**-184.8**		**-89.4**		**-89.3**	
Of which:	Oil	-64.5		-99.3		-46.5		-55.2	
	Non-oil	-54.1		-85.5		-42.9		-34.0	
	Non-Oil Non-Gold	-19.8		-36.3		-18.1		-18.0	

R: Revised P: Provisional.
Source: DGCI&S.

non-traditional markets, in particular from Southeast Asia and Latin America, has moderated.

III.2 Major exporting sectors that have been significantly affected due to weak external demand include engineering goods, gems and jewellery, textile and textile products and petroleum products. Apart from sluggish external demand, the softening of international commodity prices, particularly metal prices, might also have contributed to the reduced value of exports from some of these sectors. Despite the measures taken to ease economic and financial conditions in the US and the euro area, the risk of a further worsening of global trade prospects continues. Against the backdrop of these uncertainties, achieving the export target of US$ 360 billion during 2012-13 looks challenging.

Import contraction, mainly due to slowdown in domestic growth

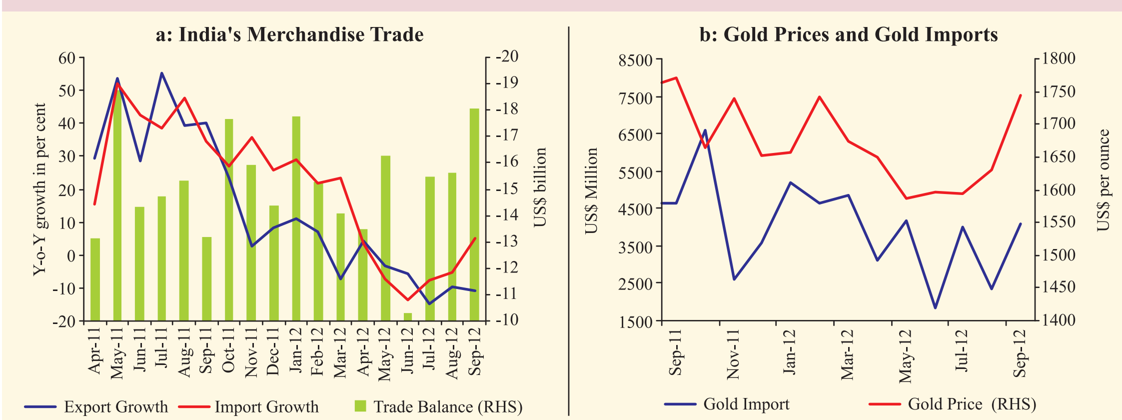
III.3 Imports contracted by 4.4 per cent during H1 of 2012-13, mainly reflecting subdued domestic economic growth coupled with depressed export prospects (Chart III.1). While the significant deceleration in economic activity helped keep the growth in petroleum, oil and lubricants (POL) imports at a moderate 6.8 per cent in H1 of 2012-13, non-oil imports declined by 9.4 per cent, largely led by significantly lower imports of gold. This possibly reflected the impact of a rise in customs duty, the policy to restrain gold loans by NBFCs and rupee depreciation. A decline in imports of export-related items and capital goods possibly indicates slowdown in export-oriented sectors and concerns relating to a slowdown in domestic investment.

III.4 With fall in exports being almost equally matched with fall in imports in value terms, India's merchandise trade deficit at about US$ 89 billion in H1 of 2012-13 was at the same level as in H1 2011-12. Going forward, with global oil prices for the Indian basket remaining firm, a reduction in the total oil import bill may be difficult. Further, export demand is likely to be constrained by deteriorating global growth prospects and decelerating global trade.

Low import and export elasticities prevent improvement of trade balance despite significant depreciation

III.5 Estimates show that the elasticity of India's non-oil exports to REER is around 0.4 with a lag of one year. This is essentially because of sizeable import content of exports and slower supply responses to price changes. Similarly, price elasticity of non-oil imports is estimated to be statistically insignificant as it includes price insensitive components like gold and also fertilisers which does not have full pass-through. Furthermore, price elasticity of net POL imports is only 0.1. Even though these estimates are sensitive to the estimation

Chart III.1: India's Merchandise Trade



methods, the time period used and the choice of variables, they indicate that the impact of depreciation of the exchange rate on India's exports and imports is low. Estimates assessing existence of 'J' curve effect show that changes in both overall trade balance (ratio of exports to imports) as also in the non-oil trade balance are statistically insignificant to REER movements.

Fall in trade deficit and higher secondary income led to lower CAD in Q1 of 2012-13

III.6 The impact of moderation in the trade deficit and improved net receipts on account of secondary income compared to Q1 of 2011-12, was discernible in a lower current account deficit in Q1 of 2012-13. Offsetting the impact of lower net receipts in services exports on CAD in Q1, secondary income, mainly representing private transfers, remained buoyant, perhaps encouraged by depreciation of the rupee. Nonetheless, the CAD-GDP ratio was marginally higher at 3.9 per cent in Q1 of 2012-13 compared with Q1 of 2011-12, mainly on account of lower nominal GDP in dollar terms partly due to depreciation of the rupee (Table III.2). Going forward, the trend in various components of services exports, particularly business services, and private transfers would largely depend on economic activities in trading partner countries and movement in the rupee exchange rate. Current indications are that CAD could widen again in Q2 of 2012-13.

Turnaround in FII flows may improve financing of CAD

III.7 Q2 of 2012-13 witnessed a turnaround in FII flows. While in Q1 of 2012-13, FIIs disinvested in the equity segment that were partially offset by their net investments in the

Table III.2: Major Items of India's Balance of Payments

(US$ billion)

	2010-11 (PR)	2011-12 (P)	2011-12 Q1 (PR)	Q2 (PR)	Q3 (PR)	Q4 (P)	2012-13 Q1 (P)
1	2	3	4	5	6	7	8
1. Goods Exports	250.6	309.8	78.8	79.6	71.5	80.0	76.7
2. Goods Imports	381.1	499.5	123.7	124.1	120.1	131.7	119.2
3. Trade Balance (1–2)	-130.5	-189.7	-44.9	-44.5	-48.6	-51.7	-42.5
4. Services Exports	131.7	140.9	33.7	32.3	37.3	37.7	34.4
5. Services Imports	83.0	76.9	17.4	18.3	21.1	20.0	20.2
6. Net Services (4–5)	48.7	64.0	16.3	14.0	16.1	17.7	14.2
7. Goods & Services Balances (3+6)	-81.8	-125.7	-28.6	-30.5	-32.4	-34.0	-28.3
8. Primary Income (Net)	-17.3	-16.0	-3.6	-4.0	-3.8	-4.6	-4.9
9. Secondary Income (Net)	53.1	63.5	14.8	15.6	16.2	16.9	16.8
10.Net Income (8+9)	35.8	47.5	11.2	11.6	12.4	12.3	11.9
11.Current Account Balance (7+10)	-46.0	-78.2	-17.4	-18.9	-20.2	-21.7	-16.4
12.Capital Account Balance	0.04	-0.1	-0.3	0.2	0.1	-0.2	-0.2
13. Financial Account Balance	48.9	80.7	18.7	19.0	20.6	22.4	16.5
of which: Change in Reserves [(-) increase/ (+) decrease]	-13.1	12.8	-5.4	-0.3	12.8	5.7	-0.5
14. Errors & Omissions (11+12–13)	-3.0	-2.4	-0.9	-0.4	-0.5	-0.6	0.1
Memo : As a ratio to GDP							
15. Trade Balance	-7.7	-10.3	-9.8	-9.9	-10.7	-10.6	-10.0
16. Net Services	2.9	3.5	3.6	3.1	3.5	3.6	3.3
17. Net Income	2.1	2.6	2.4	2.6	2.7	2.5	2.8
18. Current Account Balance	-2.7	-4.2	-3.8	-4.2	-4.4	-4.5	-3.9
19. Capital and Financial Account, Net (Excl. changes in reserves)	3.7	3.7	5.2	4.4	1.7	3.4	4.0

Note: Total of subcomponents may not tally with aggregate due to rounding off.

PR: Partially Revised. P: Preliminary.

debt segment, FII investments in Q2 improved distinctly in both segments. There was a surge in portfolio inflows after the reform measures were initiated in mid-September 2012, with net FII investment of over US$ 5.5 billion in a month and a half. FDI flows to India moderated to US$ 10.7 billion during April-August 2012 compared with US$ 19.6 billion during April-August 2011 (Table III.3).

III.8 The strong FII inflows since mid-September 2012 are mainly the outcome of a perception change among foreign investors following policy measures announced by the government (refer to Table VII.1 for details).

III.9 Balance of payment (BoP) statistics for Q1 of 2012-13 show that, overall, capital flows were sufficient to finance the CAD as evident in the marginal accretion to India's foreign exchange reserves.

III.10 Among debt-creating flows, external commercial borrowings (ECBs) witnessed some recovery in Q2 of 2012-13 over the preceding quarter, but they remained substantially lower than Q2 of 2011-12. Despite the easing of policy measures with regard to ECBs in recent months, the Indian corporate sector seems to have shied away from raising ECBs, reflecting the rising risk aversion, as also the more limited demand for such funds given the rise in corporate leverage, and slack in investment demand. Given the exchange risk or hedging cost due to economic uncertainty, ECBs involve higher debt service cost in rupee terms for corporate borrowers. Flows under trade credit and NRI deposits have been robust so far. While rupee depreciation and deregulation/increase in interest rates accelerated the momentum in flows of NRI deposits in Q1, the pace of flows has moderated in recent months (Table III.4)

III.11 Going forward, capital inflows will depend on credible implementation of reform policies, including fiscal consolidation, and global economic conditions. The recent announcement of QE3 by the US Federal Reserve is likely to be positive for capital flows to emerging economies like India. Nevertheless, the weak global and domestic growth outlook coupled with euro area risks may create uncertainty that can heighten global risk aversion.

Table III.3: Capital Flows

(US$ billion)

Component	2011-12				2012-13	
	Q1	Q2	Q3	Q4	Q1	Q2
	Average of the monthly flows					
1	2	3	4	5	6	7
FDI in India	4.1	3.1	2.3	1.5	2.0	2.4*
FDI by India	1.0	1.0	0.6	1.0	0.7	0.3*
FIIs	0.8	-0.5	0.6	4.7	-0.6	2.6
ADRs/GDRs	0.1	0.1	0.03	0.01	0.01	0.03
ECB	1.0	1.6	1.1	0.6	0.2	0.3
NRI	0.4	0.9	1.1	1.6	2.2	0.2*

*: July–August.

Rupee exhibit strengthening bias on the back of FII inflows and QE

III.12 Subsequent to a depreciation of 7.1 per cent in Q1 of 2012-13 over Q4 of 2011-12 (on average basis), the rupee remained relatively weak against the dollar in July-August 2012, largely guided by external developments. Nevertheless, net FII inflows of over US$ 3.7 billion during this period helped the rupee move in a narrow range of ₹54.6 to 56.4 per dollar. However, since the second week of September 2012, the rupee has shown recovery against the US dollar. This followed the announcement of QE3 by the US Federal Reserve that has since weakened the US dollar in the global currency markets, as also the surge in capital inflows to India following its reforms measures. Since October 8, 2012 however, rupee has weakened mainly due to demand for dollar by oil importing firms. Reflecting the trend in rupee in nominal terms, the REER based on 6-currency and 36-currency as on October 19, 2012 showed a depreciation of 4.1 per cent and 3.2 per cent, respectively, over end-March 2012 (Table III.5).

Table III.4: Disaggregated Items of Financial Account

(US$ billion)

	2010-11 (PR)	2011-12 (P)	2011-12 Q1 (PR)	Q2 (PR)	Q3 (PR)	Q4 (P)	2012-13 Q1 (P)
1	2	3	4	5	6	7	8
1. Direct Investment (net)	**9.4**	**22.1**	**9.3**	**6.5**	**5.0**	**1.4**	**4.2**
1.a Direct Investment to India	25.9	33.0	12.4	9.5	6.9	4.2	6.2
1.b Direct Investment by India	-16.5	-10.9	-3.1	-3.0	-1.9	-2.9	-2.0
2. Portfolio Investment	**28.2**	**16.6**	**2.3**	**-1.4**	**1.8**	**13.9**	**-2.0**
2.a Portfolio Investment in India	29.4	16.8	2.5	-1.6	1.9	14.1	-1.7
2.b Portfolio Investment by India	-1.2	-0.2	-0.2	0.2	-0.04	-0.2	-0.3
3. Financial Derivatives & Employee Stock Options	–	–	–	–	–	–	**-0.5**
4. Other Investment	**24.4**	**29.2**	**12.6**	**14.2**	**1.0**	**1.4**	**15.3**
4.a Other equity (ADRs/GDRs)	2.0	0.6	0.3	0.2	0.1	0.03	0.1
4.b Currency and deposits	3.8	12.1	1.2	3.1	3.2	4.6	6.5
Deposit-taking corporations, except the central bank: (NRI Deposits)	3.2	11.9	1.2	2.8	3.3	4.7	6.6
4.c Loans*	18.6	16.8	14.9	9.5	-7.7	-0.03	3.8
4.c.i Loans to India	18.3	15.7	14.9	8.9	-8.1	-0.02	3.7
Deposit-taking corporations, except the central bank	1.2	4.1	11.5	3.9	-8.7	-2.6	3.0
General government (External Assistance)	5.0	2.5	0.4	0.3	1.4	0.3	-0.1
Other sectors (ECBs)	12.2	9.1	3.0	4.7	-0.8	2.3	0.8
4.c.ii Loans by India	0.3	1.0	-0.02	0.6	0.5	-0.01	0.1
General government (External Assistance)	-0.03	-0.2	-0.04	-0.04	-0.04	-0.04	-0.1
Other sectors (ECBs)	0.3	1.2	0.02	0.6	0.5	0.03	0.1
4.d Trade credit and advances	11.0	6.7	3.1	2.9	0.6	0.2	5.4
4.e Other accounts receivable/payable - other	-11.1	-6.9	-6.8	-1.5	4.9	-3.3	-0.4
5. Reserve Assets	**-13.1**	**12.8**	**-5.4**	**-0.3**	**12.8**	**5.7**	**-0.5**
Financial Account (1+2+3+4+5)	**48.9**	**80.7**	**18.7**	**19.0**	**20.6**	**22.4**	**16.5**

*: Includes External Assistance, ECBs, non-NRI Banking Capital and Short-term trade credit.
P: Preliminary. PR: Partially Revised. – : Not available.
Note: Total of subcomponents may not tally with aggregate due to rounding off.

Table III.5: Nominal and Real Effective Exchange Rates: Trade-Based (Base: 2004-05=100)

(Variations in Per cent, appreciation+/depreciation-)

	Index Oct 19, 2012 (P)	Y-o-Y Variation (Average) 2011-12	2012-13 (Oct 19, 2012 over end-Mar 2012)
1	2	3	4
36-REER	92.3	-3.2	-3.2
36-NEER	79.4	-6.4	-4.3
30-REER	84.7	-2.9	-2.4
30-NEER	81.5	-5.4	-4.4
6-REER	105.1	-6.8	-4.1
6-NEER	76.3	-7.9	-4.5
₹/US$ (Average)	54.5	-4.9	-12.0#
₹/US$ (end-March)	53.7*	-12.7	-4.8*

NEER: Nominal Effective Exchange Rate.
REER: Real Effective Exchange Rate.
P: Provisional. *: As on October 19, 2012.
#: April-October 19, 2012 over April 2011-March 2012.
Note: Rise in indices indicates appreciation of the rupee and *vice versa*.

External debt increased moderately due to valuation gains

III.13 India's external debt registered an increase of 1.1 per cent on a q-o-q basis as at end-June 2012, primarily on account of a rise in non-resident external rupee-denominated deposits (NRE), reflecting the impact of deregulation of interest rates of these deposits in December 2011. Short-term trade credit witnessed a significant increase, due to higher utilisation of credit by oil companies because of the rise in international oil prices during the quarter. A noticeable aspect of the composition of external debt was that the stock of external commercial borrowings recorded a marginal decline due to higher repayments during the quarter (Table III.6).

Table III.6: India's External Debt

(US$ billion)

Item	End-Mar 2011 (PR)	End-Jun 2011 (PR)	End-Mar 2012 (PR)	End-Jun 2012 (QE)	Per cent Variation (5) over (4)
1	2	3	4	5	6
1. Multilateral	48.5	49.4	50.5	49.8	-1.4
2. Bilateral	25.7	26.2	26.7	27.2	1.9
3. IMF	6.3	6.4	6.2	6.0	-3.2
4. Trade Credit (above 1 year)	18.6	18.7	19.0	19.1	0.6
5. ECBs	88.6	92.7	105.2	104.8	–0.4
6. NRI Deposits	51.7	52.9	58.6	60.9	3.9
7. Rupee Debt	1.6	1.6	1.4	1.2	-14.3
8. Long-term (1 to 7)	240.9	247.7	267.5	269.1	0.6
9. Short-term	65.0	68.5	78.2	80.5	2.9
Total (8+9)	**305.9**	**316.2**	**345.7**	**349.5**	**1.1**

PR: Partially Revised. QE: Quick Estimates.

Table III.7: External Sector Vulnerability Indicators

(Ratios in per cent)

Indicator	End-Mar 2011	End-Mar 2012	End-Jun 2012
1	2	3	4
Ratio of Total Debt to GDP	17.8	20.0	21.7
Ratio of Short-term to Total Debt (Original Maturity)	21.2	22.6	23.0
Ratio of Short-term to Total Debt (Residual Maturity)	42.2	42.6	42.9
Ratio of Concessional Debt to Total Debt	15.5	13.9	13.5
Ratio of Reserves to Total Debt	99.6	85.2	82.9
Ratio of Short-term Debt to Reserves	21.3	26.6	27.8
Reserves Cover of Imports (in months)	9.6	7.1	7.0
Reserves Cover of Imports and Debt Service Payments (in months)	9.1	6.8	6.6
Debt-Service Ratio (Debt Service Payments to Current Receipts)	4.3	6.0	5.9
External Debt (US$ billion)	305.9	345.7	349.5

III.14 The CAD during Q1 of 2012-13 was largely financed through debt flows, with continued uncertainty in the global economy affecting the quantum of equity flows. However, the magnitude of increase in external debt was lower than that of the preceding quarter largely due to valuation gains of US$ 7.9 billion during Q1 resulting from appreciation of the US dollar against the Indian rupee and other international currencies. Thus, excluding the valuation gains, the stock of external debt as at end-June 2012 would have increased by 11.8 billion.

External vulnerability indicators witnessed deterioration, but remain comparable with peers

III.15 There was some deterioration in the major indicators considered for assessing the vulnerability of the external sector in Q1 of 2012-13 (Table III.7). Key indicators of external sector vulnerability, such as debt-GDP ratio, short-term debt as per cent to total debt as well as to foreign exchange reserves and import cover, deteriorated as at end-June 2012 compared to end-March 2012.

III.16 India's NIIP as represented by net international liabilities, improved to US$ 220.3 billion at end-June 2012 from US$ 244.2 billion at end-March 2012. Accordingly, the NIIP/GDP ratio at end-June 2012 declined compared with that at end-March 2012. The improvement in NIIP was essentially on account of the valuation changes emanating from exchange rate movements (Table III.8).

III.17 Historical data suggests some improvement in the major indicators of external vulnerability, such as foreign exchange reserves to total debt ratio, short-term debt to foreign exchange reserves and external debt to GDP ratio over the past two decades (Chart III.2). However, more recently, there has been some deterioration in these indicators. Short-term debt to total debt ratio has risen since 2004-05. Moreover, in the recent years, while the ratio of foreign exchange reserves to total debt has declined, the ratio of short-term debt to foreign exchange reserves has increased. These trends are a matter of concern although foreign exchange reserves provide a cushion.

III.18 A cross-country analysis highlights the relatively robust position of India compared with

Chart III.2: External Vulnerability Indicators: India

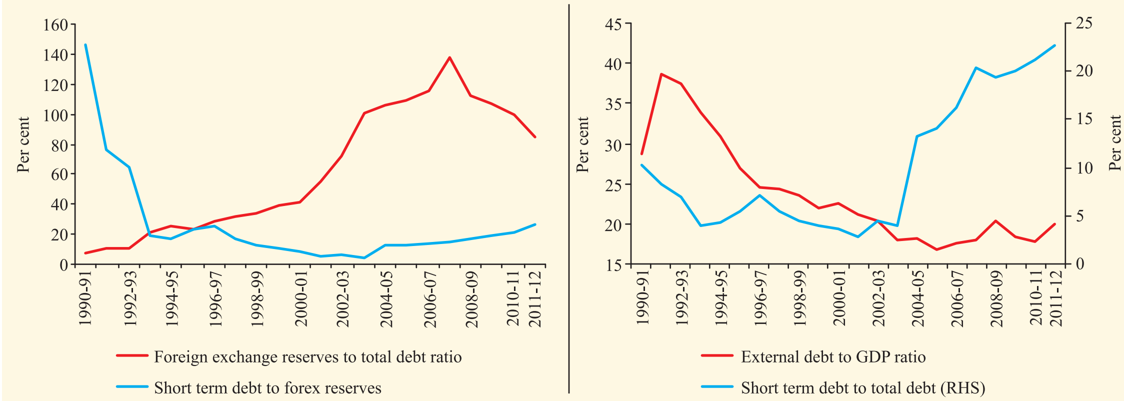


Table III.8: Overall International Investment Position of India

(US$ billion)

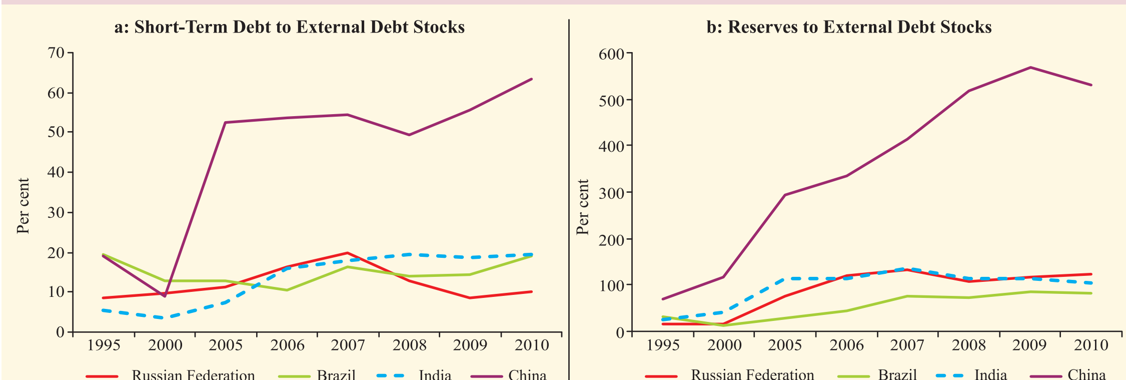
Period	Mar-11 (PR)	Jun-11 (PR)	Sep-11 (PR)	Dec-11 (PR)	Mar-12 (PR)	Jun-12 (P)
1	2	3	4	5	6	7
Net IIP	-203.6	-216.1	-196.0	-204.7	-244.2	-220.3
Assets	439.8	450.0	453.9	431.6	437.1	433.5
Liabilities	643.4	666.1	649.8	636.2	681.3	653.9
Net IIP-GDP Ratio*	-12.1	-12.2	-10.7	-11.1	-13.2	-12.2

* Based on annualised GDP. PR: Partially Revised.
P: Preliminary.

other indebted developing countries. According to the Global Development Finance Report, 2012, in terms of ratio of external debt to GNI at end-2010, India's position was the fifth lowest among the top 20 developing debtor countries. In terms of short-term to total external debt stock, as also foreign exchange reserves to external debt stocks, India's position is comparable to other BRIC countries, except China. Even though China's short-term debt to total external debt ratio is very high, its foreign exchange reserves are also high, thus providing adequate cover (Chart III.3).

III.19 In sum, India's external sector faces some sustainability issues that emanate from large current account imbalances. Although reserves coverage and manageable external debt provide some comfort, macro-financial policies aimed at lowering inflation, containing demand by more restrained fiscal spending, improving trade competitiveness through structural and other policies and the direct use of trade policy measures would be needed for medium-term sustainability.

Chart III.3: External Vulnerability Indicators: BRIC Countries



Source : Global Development Finance, World Bank, 2012

Source : Global Development Finance, World Bank, 2012